90-1273

No.

Supreme Court, U.S.
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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1990

TITAN CAPITAL CORPORATION,
Petitioner,

VS.

KAY HOLLINGER, et al.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTION PRESENTED:

Whether the common-law doctrine of respondeat superior overrides the "good faith" language of § 20(a) of the Securities Exchange Act of 1934 and subjects principals to strict liability for violations of § 10(b) of that Act and rule 10b-5 by their agents.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF AUTHORITIES	iii
OPINIONS BELOW	1
JURISDICTION	1
STATUTES AND REGULATIONS INVOLVED	2
STATEMENT OF THE CASE	2
REASONS FOR GRANTING THE WRIT	7
I.	
The Decision of the Court of Appeals for the Ninth Circuit, Along with the Decisions of the First, Second, Eighth and Tenth Circuits, Conflicts with the Decisions of the Third, Fourth and Sixth Circuits	7
II.	
The Decision of the Court of Appeals Conflicts with this Court's Decision in *Ernst & Ernst v. Hochfelder* and with the Express Language of § 20(a) of the Securities Exchange Act of 1934	11
III.	
The Decision of the Court of Appeals Raises An Important Federal Question That Has Not Been, But Should Be, Settled By The Court	13
CONCLUSION	14
INDEX TO APPENDICES	
Appendix A. Opinion of the United States Court of Appeals for the Ninth Circuit	1a
Appendix B. Order Granting Motion for Summary Judgment	1b
Appendix C. Order Denying Motion for Reconsideration	1c
Appendix D. Statutes and Regulations	1d

TABLE OF AUTHORITIES

Cases

	Page
Atlantic Fin. Management, Inc., In re, 784 F.2d 29 (1st Cir. 1986), *cert. denied,* 481 U.S. 1072 (1987)	7
Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)	9
Carpenter v. Harris, Upham & Co., Inc., 594 F.2d 388 (4th Cir. 1979)	8
Carras v. Burns, 516 F.2d 251 (4th Cir. 1975)	8
Castleglen Inc. v. Commonwealth Savings Ass'n, 689 F.Supp. 1069 (D. Utah 1988)	7
Commerford v. Olson, 794 F.2d 1319 (8th Cir. 1986)	7
Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)	9, 11, 12, 13, 14
Holloway v. Howerdd, 536 F.2d 690 (6th Cir. 1976)	8
Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689 (9th Cir. 1967), *cert. dismissed,* 393 U.S. 801 (1968)	9
Kerbs v. Fall River Industries, Inc., 502 F.2d 731 (10th Cir. 1974)	7
Marbury Management Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied,* 449 U.S. 1011 (1980)	7
Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980)	7
Pinter v. Dahl, 486 U.S. 622 (1988)	10
Seattle-First National Bank v. Carlstedt, 678 F.Supp. 1543 (W. D. Okla. 1987)	8

TABLE OF AUTHORITIES

CASES

Page

Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982) 8

Statutes

Code of Federal Regulations

Sec. 230.405 ..... 2, 12

Sec. 240.10b-5 ..... 2, 3

Sec. 240.12b-2 ..... 2, 12

United States Code, Title 15

Sec. 77l(2) 2, 3, 6, 7

Sec. 77o 2, 3, 7, 13

Sec. 78j(b) 2, 3, 9, 11, 12, 14

Sec. 78o(b)(4) 3

Sec. 78t(a) ..... *passim*

Sec. 78bb(a) 2, 9, 10

United States Code, Title 18

Sec. 1961, *et seq.* 3

United States Code, Title 28

Sec. 1254(1) 1

Textbooks

Restatement (Second) of Agency § 219 (1958) ... 8

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A) is reported at 914 F. 2d 1564 (9th Cir. 1990). The order of the district court (Pet. App. B), and its order on motion for reconsideration (Pet. App. C) are not reported.

JURISDICTION

The judgment of the court of appeals was filed September 27, 1990, and amended November 13, 1990. A petition for rehearing was denied on November 13, 1990. Jurisdiction in this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved in this case are set forth in full in the appendix (Pet. App. D). The citations to the statutes and regulations are as follows:

Securities Exchange Act of 1933,
Section 12(2), 15 U.S.C. § 77l(2)
Section 15, 15 U.S.C. § 77o

Securities Exchange Act of 1934,
Section 10(b), 15 U.S.C. § 78j(b)
Section 20(a), 15 U.S.C. § 78t(a)
Section 28(a), 15 U.S.C. § 78bb(a)

Securities and Exchange Commission,
17 C.F.R. § 230.405
17 C.F.R. § 240.10b-5
17 C.F.R. § 240.12b-2

STATEMENT OF THE CASE

Plaintiffs and respondents Kay Hollinger, Richard Lewellyn Jones, Edward E. Nissen, Judy D'Arcy, and K-Judy Ltd.[1] (hereinafter sometimes collectively referred to as "respondents") filed their "complaint for damages" against defendant and petitioner Titan Capital Corporation[2] ("Titan") and defendants Emil Wilkowski ("Wilkowski") and Painter Financial Group, Ltd.[3] ("Painter") on December 13, 1984 in the United States District Court

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[1]K-Judy Ltd. is alleged in plaintiffs' complaint to be a Washington corporation.

[2]Titan Capital Corporation is now known as TITAN/Value Equities Group, Inc., and has no parent or non-wholly owned subsidiaries.

[3]Painter Financial Group, Inc. is alleged in plaintiffs' complaint to be a Washington corporation.

for the Western District of Washington at Seattle. The complaint consists of eleven separate claims for relief. Respondents allege federal claims for violations of § 10(b) of the Securities Exchange Act of 1934[4] ("Exchange Act") and rule 10b-5[5] promulgated thereunder by the Securities and Exchange Commission; § 12(2) of the Securities Act of 1933[6] ("Securities Act"); § 15(b)(4) of the Exchange Act[7]; and the Racketeer Influenced and Corrupt Organizations Act.[8] Although "controlling person" liability is not specifically alleged in the complaint, Titan interpreted respondents' complaint as alleging indirect liability against it that encompassed claims under § 20(a) of the Exchange Act[9] and § 15 of the Securities Act.[10] Thus, the issue of "controlling person" liability against Titan under those sections was discussed in the district court and the court of appeals.

Respondents' remaining seven claims for relief are based on alleged violations of state law and are present in the federal forum because of the principle of pendent jurisdiction. Respondents have denominated these pendent state law claims as: "Violation of Blue Sky Law", "Violation of Consumer Protection Act", "Conversion", "Common Law Fraud", "Breach of Fiduciary Duty", and "Negligence".

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[4]15 U.S.C. § 78j(b).

[5]17 C.F.R. § 240.10b-5.

[6]15 U.S.C. § 77l(2).

[7]15 U.S.C. § 78o(b)(4).

[8]18 U.S.C. § 1961, *et seq.*

[9]15 U.S.C. § 78t(a).

[10]15 U.S.C. § 77o.

The allegations as to the basis of subject matter jurisdiction over respondents' claims in the federal district court are made in the fifth paragraph of respondents' complaint. Respondents allege "subject matter competence over this action pursuant to 15 U.S.C. § 77v, 15 U.S.C. § 78aa, 28 U.S.C. §§ 1331, 1332, 18 U.S.C. § 1964 and the principles of pendent jurisdiction".

The complaint's allegations and discovery have disclosed that in 1979, respondent Kay Hollinger ("Hollinger") and respondent Judy D'Arcy ("D'Arcy") formed a business which was incorporated in 1982 or 1983 as K-Judy, Ltd. In April or May of 1983, respondents Hollinger and D'Arcy met Wilkowski. They gave a check payable to Painter, a financial planning and insurance firm for which Wilkowski worked, to Wilkowski, and he began providing bookkeeping and insurance services for K-Judy.

In November of 1983, a representative of Painter became a registered principal of Titan, and late that same month Wilkowski and several other Painter representatives applied to become registered with the National Association of Securities Dealers ("NASD") and the State of Washington as representatives of Titan for the solicitation and sale of securities. On December 22, 1983, Wilkowski was approved for registration with the NASD, and on January 26, 1984, the State of Washington cleared him for transactions through Titan. In his application for registration, Wilkowski represented, *inter alia*, that he had never been arrested or indicted for any felony or misdemeanor in which dishonesty, wrongful taking of property, or any manner of fraud was a factor, and that he had not been convicted of or pleaded guilty or *nolo contendere* to any felony or misdemeanor except a minor traffic violation.

On February 13, 1984, following its standard investigation, the NASD advised Titan that Wilkowski had been convicted of three counts of first degree forgery in 1971, as well as driving while intoxicated in 1981. The NASD requested an amended registration form with details and an explanation of the failure to disclose these criminal convictions. Wilkowski explained that he had pleaded guilty to one count of forgery in 1971 and was placed on probation pending restitution; he understood that once restitution was complete the court would expunge its record of the crime and he could truthfully state he had not been convicted. Wilkowski was subsequently cleared by the NASD with an "unconditional" license.

Beginning in November of 1983, D'Arcy and Hollinger made a number of investments processed through Titan. In addition, from October of 1983 through June of 1984, D'Arcy, Hollinger, respondent Edward Nissen ("Nissen"), the father of Hollinger, and respondent Lewellyn Jones ("Jones"), a personal friend of Hollinger and legal advisor to K-Judy, gave cash and checks payable to Wilkowski personally, purportedly for investments. None of these payments was processed through Titan, and neither Nissen nor Jones ever made an investment processed through Titan.

D'Arcy, Hollinger, and Nissen all subsequently received bogus reports and receipts fabricated by Wilkowski for the investments not processed through Titan. Wilkowski apparently defalcated all funds not processed through Titan. In June of 1984, Titan learned of claims that Wilkowski had defalcated funds, suspended him immediately pending investigation, and subsequently terminated him. Wilkowski disappeared. Once Wilkowski was located, criminal proceedings were instituted against him, and he pleaded guilty to charges of state securities

fraud and grand theft arising from his defalcation of funds supplied by plaintiffs and others.[11]

Titan moved for summary judgment on respondents' federal claims and for dismissal of the pendent claims without prejudice. The motion was granted.[12] Respondents appealed, and on appeal a panel of the Ninth Circuit Court of Appeals called *sua sponte* for the case to be heard *en banc* to review various questions, including the question "[m]ay broker-dealers be held vicariously liable under the common-law doctrine of respondeat superior for securities law violations committed by their registered representatives?" The Ninth Circuit answered this question in the affirmative,[13] concluding that "we are now satisfied that 'the "controlling person" provision of Section 20(a) was not intended to supplant the application of agency principles in securities cases, and that it was enacted to expand rather than to restrict the scope of liability under the securities laws'. [Citations omitted]".[14] The Ninth Circuit reasoned that "[o]nly if both respondeat superior and § 20(a) are available is the statutory scheme comprehensive and the public protected by the federal securities laws."[15]

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[11]Wilkowski was served with plaintiffs' district court action and a default judgment has been entered against him.

[12]Pet. App. B.

[13]Pet. App. A.

[14]*Id.* at 32.

[15]*Id.* The Ninth Circuit also appears to have held, without discussion, that Titan can be held liable for Wilkowski's violations of § 12(2) of the Securities Act under respondeat superior, regardless of whether Titan meets the test in § 15 of the Securities Act that it had "no knowledge of or reasonable ground to believe in the facts underlying" Wilkowski's violation. *Id.* at 34. Thus, a subsidiary

REASONS FOR GRANTING THE WRIT

I.

The Decision of the Court of Appeals for the Ninth Circuit, Along with the Decisions of the First, Second, Eighth and Tenth Circuits, Conflicts with the Decisions of the Third, Fourth and Sixth Circuits.

Under § 20(a) of the Exchange Act a "controlling person [who] acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action" is not liable for the controlled person's violation of any provision of the Exchange Act or rule or regulation thereunder. In spite of this express language, the Ninth Circuit in the instant case, as have the First,[16] Second,[17] Fifth,[18] Eighth,[19] and Tenth[20] Circuits, held that

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question in the instant case is whether respondeat superior overrides the language of § 15 of the Securities Act and subjects principals to strict liability for violations of § 12(2) of that Act by their agents.

[16] *In re Atlantic Fin. Management, Inc.*, 784 F.2d 29 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987). In *Atlantic*, however, the First Circuit distinguished between "respondeat superior", a status-based agency liability theory, and "apparent authority", an authority-based agency liability theory, and held that § 20(a) does not preclude assertion of liability based only on common law notions of "apparent authority". *Id.* at 35.

[17] *Marbury Management, Inc. v. Kohn*, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

[18] *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111 (5th Cir. 1980).

[19] *Commerford v. Olson*, 794 F.2d 1319 (8th Cir. 1986).

[20] *Kerbs v. Fall River Industries, Inc.*, 502 F.2d 731 (10th Cir. 1974). *But see Castleglen, Inc. v. Commonwealth Savings Ass'n*, 689 F.Supp. 1069, 1071 (D. Utah 1988) (the Tenth Circuit in *Kerbs* "never discussed the effect of § 20(a) on respondeat superior liability");

the limitation on secondary liability set forth in § 20(a) is not available to principals, and that principals can be held strictly liable under the Exchange Act for the acts of their agents under the common-law doctrine of respondeat superior. In contrast, § 20(a) has been utilized as the sole means of imposing secondary liability under the Exchange Act under decisions of the Third,[21] Fourth,[22] and Sixth[23] Circuits. By engrafting the common-law doctrine of respondeat superior onto the Exchange Act as a means of imposing secondary liability, the First, Second, Fifth, Eighth, Tenth and now Ninth Circuits have eviscerated the legislative scheme. Under the decisions in those circuits, principals can be held strictly liable[24] under the Exchange Act for a violation of the Act by an agent

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Seattle-First National Bank v. Carlstedt, 678 F.Supp. 1543, 1548 n. 1 (W. D. Okla. 1987) ("there is some question as to whether 'agency' or *respondeat superior* theories state a basis for recovery under the federal securities laws").

[21]*Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982). In *Sharp*, however, the Third Circuit announced an "exception" that permits use of respondeat superior to impose liability under the Exchange Act against "brokerage firms" and "accounting firms that render investment-oriented opinion letters." 649 F.2d at 181-82.

[22]*Carpenter v. Harris, Upham & Co., Inc.*, 594 F.2d 388 (4th Cir. 1979). *But see Carras v. Burns*, 516 F.2d 251 (4th Cir. 1975). The apparent conflict between these Fourth Circuit decisions has yet to be resolved.

[23]*Holloway v. Howerdd*, 536 F.2d 690 (6th Cir. 1976). The Ninth Circuit in the instant case cited *Holloway* as support for its decision, Pet. App. A at 29 n.27, while the dissent cited it as a decision in which a circuit court of appeals declined to impose liability under the Exchange Act based on respondeat superior, *id.* at 45-46. (Hall, J., dissenting).

[24]Respondeat superior is a strict liability doctrine. *See* Restatement (Second) of Agency § 219 (1958) (a master is liable for the torts of

regardless of fault. By incorporating respondeat superior into the Exchange Act, these circuit courts of appeals have discarded the state of mind restrictions on liability included by Congress in § 10(b) of the Act[25] and treated the language of § 20(a) of the Act as mere surplusage.

In the instant case, the Ninth Circuit cast aside over 20 years of precedent[26] establishing that § 20(a) supplants[27] the common-law doctrine of respondent superior in Exchange Act cases. The Ninth Circuit's stated reasons for its reversal were that § 20(a) was "intended to expand rather than to restrict the scope of liability under the securities laws"[28] and that "[o]nly if both respondeat superior and § 20(a) are available is the statutory scheme comprehensive and the public protected by the federal

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his servants committed while acting in the scope of their employment). *See also* Pet. App. A at 42-43. (Hall, J., dissenting).

[25]In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court held that an intent to deceive, manipulate, or defraud is required for civil liability under § 10(b) and rule 10b-5.

[26]*See Kamen & Co. v. Paul H. Aschkar & Co.*, 382 F.2d 689 (9th Cir. 1967), *cert. dismissed*, 393 U.S. 801 (1968).

[27]Use of the term "supplant" by the Ninth Circuit was unfortunate to the extent that it intimated preemption rather than exclusivity within the statutory framework of the Exchange Act. Litigants in federal court could assert the applicability of respondeat superior in connection with state law claims based on the same facts as their federal claims even under prior Ninth Circuit law because of § 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a). That section provides that "[t]he rights and remedies provided by this chapter shall be in addition to all other rights and remedies that may exist at law or in equity. . . ." *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 738 n. 9 (1975) (plaintiff, an offeree but not a purchaser, had no rule 10b-5 claim, but might still have a state law claim because of § 28(a)).

[28]Pet. App. A at 32.

securities laws."[29] Such reasoning ignores the rules of statutory construction for determining the scope of liability established by this Court in its decisions. As this Court recently stated with respect to the scope of liability of the Securities Act:

> The ascertainment of congressional intent with respect to the scope of liability created by a particular section of the Securities Act must rest primarily on the language of that section. See Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 472, 51 L.Ed.2d 480, 97 S.Ct. 1292 (1977). The broad remedial goals of the Securities Act are insufficient justification for interpreting a specific provision " 'more broadly than its language and the statutory scheme reasonably permit.' " Touche Ross, 442 U.S., at 578, 61 L.Ed.2d 82, 99 S.Ct. 2479, quoting SEC v. Sloan, 436 U.S. 103, 116, 56 L.Ed.2d 148, 98 S.Ct. 1702 (1978). We must assume that Congress meant what it said.[30]

The Ninth Circuit's ascertainment of congressional intent in this case rested not on the language of § 20(a), but rather, on its perception of the need to make the statute "comprehensive" and thus protect "the public". The language of § 20(a) of the Exchange Act, however, does not limit the good faith defense to controlling persons other than principals. Moreover, no other language in the Exchange Act suggests that Congress intended for respondeat superior to apply to impose strict liability under the Exchange Act.[31] This Court should therefore

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[29] *Id.*

[30] *Pinter v. Dahl*, 486 U.S. 622, 653 (1988).

[31] On the contrary, § 28(a) reflects that the provisions of the Exchange Act do not preempt state law rights and remedies. See note 27 *supra*.

resolve the conflict among the circuit courts of appeals by holding that the common-law doctrine of respondeat superior is not applicable to Exchange Act claims, and that the good faith defense of § 20(a) is available to all controlling persons, including principals.

II.

The Decision of the Court of Appeals Conflicts with this Court's Decision in *Ernst & Ernst v. Hochfelder* and with the Express Language of § 20(a) of the Securities Exchange Act of 1934.

In *Ernst & Ernst v. Hochfelder*,[32] this Court considered whether negligent conduct would suffice to impose civil liability under § 10(b) of the Exchange Act and rule 10b-5 promulgated thereunder, or whether scienter — an intent to deceive, manipulate, or defraud — is required. In adopting the latter requirement, this Court concluded:

> There is no indication that Congress intended anyone to be made liable [under the Exchange Act] for [manipulative and deceptive] practices unless he acted other than in good faith. The catch-all provision of § 10(b) should be interpreted no more broadly.[33]

While in *Hochfelder* this Court determined that Congress contemplated scienter rather than negligence as a requirement for imposition of civil liability under § 10(b), the Ninth Circuit in this case has eliminated any state of mind condition or fault requirement under § 10(b) by holding that principals can be held strictly liable seconda-

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[32] 425 U.S. 185 (1976).

[33] *Id.* at 206.

rily for violations of § 10(b) and rule 10b-5 by their agents.

The Ninth Circuit's decision does not only conflict with the decision in *Hochfelder* concerning liability under § 10(b), however. It contravenes the express language of § 20(a) of the Exchange Act which exculpates a controlling person from liability for the acts of a controlled person if the controlling person "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."[34] While the Court in *Hochfelder* did not directly address the applicability of respondeat superior to the Exchange Act, it cited § 20(a) as evidence supporting its conclusion that "[e]ach of the provisions of the 1934 Act that expressly create civil liability . . . contains a state of mind condition requiring something more than negligence".[35]

Since Congress requires "something more than negligence" in both § 20(a) and § 10(b) for civil liability under those sections, the Ninth Circuit has undermined Congress' legislative scheme and this Court's holding in *Hochfelder* by imposing strict liability under respondeat superior on principals for violations of § 10(b) by their agents. Nothing in § 20(a) or any other provision of the Exchange Act suggests that the scope of the "good faith" defense of § 20(a) should be limited to controlling persons other than principals. As this Court noted in *Hochfelder* "the language of a statute controls when

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[34]The Securities and Exchange Commission has defined "control" under both Acts as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405; 17 C.F.R. § 240.12b-2.

[35]425 U.S. at 209 n. 28.

sufficiently clear in its context"[36] and "there is no occasion to examine ... additional considerations of 'policy' ".[37]

The Ninth Circuit's decision was based on policy considerations and contravenes the express language of § 20(a) of the Exchange Act and this Court's holding in *Ernst & Ernst v. Hochfelder*. Thus, the instant case requires an exercise of this Court's power of supervision.

III.

The Decision of the Court of Appeals Raises An Important Federal Question That Has Not Been, But Should Be, Settled By The Court.

The decision of the court of appeals in the instant case raises the question of the applicability of common-law doctrines to the Exchange Act. This is an important question that has not been, but should be, settled by this Court. The Ninth Circuit's conclusion that § 20(a) "was intended to expand rather than to restrict the scope of liability under the securities laws"[38] and that therefore respondeat superior applies to the Exchange Act begs the question whether the common-law doctrine of respondeat superior was intended by Congress as a means of imposing liability under the Act. Congress clearly was cognizant of agency concepts in drafting the securities laws. An example of a means of "control" set forth in the Securities Act is "agency".[39] Agency is therefore one method of establishing the controlling person relationship

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[36] *Id.* at 201.

[37] *Id.* at 214 n. 33.

[38] Pet. App. A at 32.

[39] 15 U.S.C. § 77o.

under § 20(a).[40] Much less logical is the Ninth Circuit's conclusion that a common-law theory of secondary liability relating to agency should be applied to the statutory framework of the Exchange Act, especially when that theory's state of mind requirement for imposing liability is two steps removed from scienter, the requirement for both primary liability under § 10(b) and secondary liability under § 20(a).

In *Hochfelder* this Court reserved the question whether the common-law doctrine of aiding and abetting liability could be used to impose liability under the Exchange Act, but implied that any such liability would need to be based upon a finding of scienter.[41] In the instant case the Ninth Circuit held to the contrary by permitting imposition of secondary liability for violations of § 10(b) on a strict liability basis under respondeat superior. Since the applicability of common-law doctrines to the Exchange Act is an important federal question that has not been, but should be, settled by this Court, a writ of certiorari should be granted.

CONCLUSION

A review of the issue in the instant case by this Court will resolve a conflict among the circuit courts of appeals, settle a conflict between a decision of a court of appeals and an applicable decision of this Court, and answer the question whether common-law doctrines apply to impose liability under the Securities Exchange Act of 1934. For

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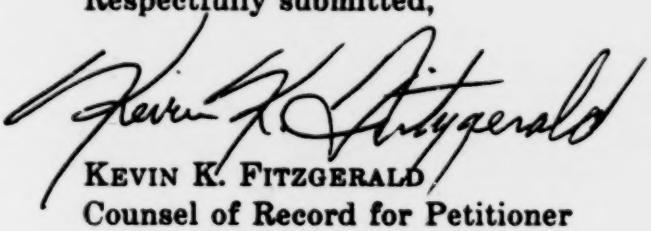
[40]The Ninth Circuit in its decision in the instant case went so far as to hold that as a matter of law a broker-dealer is a controlling person under § 20(a) with respect to its registered representatives. Pet. App. A at 25-26.

[41]425 U.S. at 191 n. 7.

these reasons petitioner respectfully requests that this petition for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit be granted.

DATED: February 6, 1991.

Respectfully submitted,



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APPENDIX A

APPENDIX A

No. 87-3837

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

KAY HOLLINGER; RICHARD LLEWELYN JONES; EDWARD E. NISSEN; JUDY D'ARCY; K-JUDY, LTD.,
Plaintiffs-Appellants,

VS.

TITAN CAPITAL CORP.; EMIL WILKOWSKI; PAINTER FINANCIAL GROUP, LTD.,
Defendants-Appellees.

D.C. No. CV-84-1706-D

ORDER AND AMENDED OPINION

Appeal from the United States District Court
for the Western District of Washington
Carolyn R. Dimmick, District Judge, Presiding

Argued and Submitted
March 22, 1990 — Pasadena, California

Filed September 27, 1990
Amended November 13, 1990

Before: Goodwin, Chief Judge, Schroeder, Alarcon, Norris, Nelson, Canby, Hall, Wiggins, Brunetti, Thompson, and Rymer, Circuit Judges.

Opinion by Judge Norris; Dissent by Judge Hall with whom Judge Rymer, joins

SUMMARY
Securities

Affirming in part and reversing in part a district court judgment, the court of appeals held that a securities broker-dealer was not required to inform investors of a representative's prior forgery conviction under the federal securities laws.

Victimized invstors sought to recover losses from a brokerage firm and a financial counseling firm with which Emil Wilkowski, a sales representative, was associated. An FBI report disclosed that Wilkowski had an eleven year old prior conviction for forgery. The National Association of Securities Dealers (NASD) did not revoke Wilkowski's registration upon learning of the conviction. The broker-dealer firm chose to continue Wilkowski's employment. The financial counseling firm, however, terminated Wilkowski as a financial counselor. During the course of his employment, Wilkowski misappropriated investors' funds, and was ultimately convicted of criminal securities fraud and grand theft. Appellant Kay Hollinger and others sought to recover their losses under various antifraud provisions of the federal securities laws and under state law. The district court granted summary judgment to both the broker-dealer, and the financial counseling firm on all of appellant's federal claims, and dismissed the pendent state claims.

[1] The Ninth Circuit continued to adhere to the view that recklessness may satisfy the element of scienter in a civil action for damages under section 10(b) and Rule 10b-5. [2] A reckless omission of material facts upon which appellant put justifiable reliance in connection with a sale or purchase of securities is actionable under section 10(b) and Rule 10b-5. [3] In adopting this standard of recklessness, the court put to rest the "flexible duty

standard," because it was essentially a negligence standard. [4] A broker-dealer is not required to inform investors of every negative fact it knows about its registered representatives. Here, the court concluded that the broker's failure to disclose Wilkowski's eleven year old conviction did not create such an unreasonable risk to investors that the broker's failure to disclose the conviction was an extreme departure from the standard of ordinary care. [5] The court also rejected appellant's claim that the broker should be primarily liable for failing to inform them that Wilkowski had not made full restitution on his prior conviction to the individuals he defrauded. A fair-minded jury could not infer that the broker knew that Wilkowski did not make restitution under his previous plea agreement. [6] The court ruled that a broker-dealer is a controlling person that could be held vicariously liable under section 20(a) of the 1934 Act. [7] The court rejected the argument that it could avoid the imposed duty to supervise its representatives simply by labeling them "independent contractors." [8] Appellant was not required to show "culpable participation" by the broker to establish that it was a controlling person under section 20(a). [9] However, the broker could avoid liability as a controlling person if it acted in good faith and did not directly or indirectly induce the violations. [10] The district court erred in ruling that because the broker had adopted rules for accepting investment payments and for supervising a contractor's compliance with securities laws and regulations, it had satisfied its duty to supervise. The broker had to show that its supervisory system was adequate and that it reasonably discharged its responsibilities under the system. [11] After reexamination of the issue as an en banc court, the court ruled that the controlling person provision of section 20(a) was not intended to supplant the

application of agency principles in securities cases; rather it was enacted to expand rather than to restrict the scope of liability under the securities laws. [12] Whether appellants would ultimately be able to hold the broker liable under either section 20(a) or respondeat superior depended on issues to be resolved on remand. Appellants could proceed on their theories of liability based on both section 20(a) and respondeat superior because it is no longer the law of this circuit that the former supplants the latter. [13] The court reversed the district court grant of summary judgment to the broker on the claim that it was secondarily liable under section 15 of the 1933 Act. The broker was also a controlling person under this section, having the same good faith defense available to it as under section 20(a). [14] The court affirmed the district court's grant of summary judgment in favor of the financial consulting firm on appellant's federal securities laws claims. Because the firm was not a registered broker-dealer, nor did it engage in the sale of securities, it could not be considered a controlling person. No evidence was produced that the firm exercised actual power and influence over Wilkowski's actions in embezzling funds.

Judges Hall and Rymer dissented. Although they concurred with most of the majority's opinion, they would hold that section 20(a) of the Act precludes the grafting of the common law doctrine of respondeat superior onto a federal securities law action.

COUNSEL

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James S. Scott and James M. Shaker, Scott & Scott, Yakima, Washington, for the defendant-appellee Painter Financial Group, Ltd.

Paul Gonson, Securities and Exchange Commission, Washington, D.C., for the amicus curiae, Securities and Exchange Commission.

W. Reese Bader and Barbara Moses, Orrick, Herrington & Sutcliffe, San Francisco, California, for the amicus curiae, Securities Industry Association.

ORDER

The opinion is amended as follows:

Slip op. at 12095, line 17, instead of "In response to the SEC, Titan contends that even if it," insert "In contrast to the SEC's position, the district court's reasoning implied that even if Titan"

Slip op. at 12095, line 22, insert footnote after "not an agent": "This argument was never advanced by Titan. Titan acknowledged a duty to supervise Wilkowski and argued that its supervision of him was adequate."

Slip op. at 12096, line 14, instead of "Titan's argument", insert "the argument"

Slip op. at 12100, line 7, insert at end of paragraph: "The evidence below raised material issues of fact as to whether Titan's supervision of Wilkowski was sufficient to entitle Titan to the good faith defense. Summary judgment was, accordingly, improper."

The petition for rehearing is DENIED.

OPINION

NORRIS, Circuit Judge:

Emil Wilkowski, a dishonest securities salesman, embezzled money entrusted to him by four clients. As a result, Wilkowski was convicted of criminal securities fraud and grand theft. In this civil action for alleged violations of federal securities and state laws, the victimized investors seek to recover their losses from a brokerage firm and a financial counseling firm with which Wilkowski was associated. The district court granted summary judgment to both defendants, which plaintiffs now appeal.

On appeal, the panel called *sua sponte* for the case to be heard *en banc* to review various questions of Ninth Circuit securities law raised by this case. They are as follows:

1. What standard of recklessness meets the scienter requirement for a claim under § 10(b) and Rule 10b-5?[1]

2. Is a broker-dealer a "controlling person" with respect to its registered representatives within the meaning of § 20(a) of the 1934 Act?[2] And does plaintiff or defendant bear the burden of providing the good faith exception to controlling person liability under § 20(a)?

3. May broker-dealers be held vicariously liable under the common law doctrine of respondeat superior for

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[1]Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78j(b) and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5.

[2]Section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a).

securities law violations committed by their registered representatives?

We will address each of these questions in the course of considering appellants' various claims under the federal securities laws.

I

Defendant/appellee Painter Financial Group, Ltd. ("Painter") was formed in May 1983 to provide financial counseling and to sell insurance to individuals and small businesses. Shortly thereafter, Emil Wilkowski rented space in Painter's office in Bellevue, Washington, from which he sold insurance and counseled individuals as a Painter representative. During the summer of 1983, Wilkowski met appellants Judy D'Arcy and Kay Hollinger, two business partners who were seeking financial advice. Wilkowski assisted them with a real estate transaction and was soon doing their bookkeeping, advising them on tax matters, and offering them investment advice.

In November 1983, Wilkowski and several other Painter representatives in the Bellevue office applied to the National Association of Securities Dealers ("NASD") for registration as securities salesmen for defendant/appellee Titan Capital Corporation ("Titan"), a registered broker-dealer firm regulated by the Securities and Exchange Commission ("SEC") and by the NASD. Sales representatives of broker-dealers must be registered with the NASD if the broker-dealer is a member of this self-regulatory organization.

When Wilkowski filled out his application for registration with the NASD, he answered "no" to questions asking whether he had ever willfully made a false statement, been the subject of a major legal proceeding, or

been convicted or pleaded guilty to a felony. He supplied a photo and fingerprints as requested. The NASD registered Wilkowski as a securities salesman for Titan on December 12, 1983, and on January 26, 1984, Wilkowski entered into a contract in which Titan authorized him to engage in the securities business as a registered representative of Titan, operating out of Painter's office in Bellevue. That office became a Titan branch office: Titan provided Wilkowski with business cards and stationery and required the office to display a sign with Titan's logo.

As part of its usual registration process, the NASD requested the FBI to run a fingerprint check on Wilkowski. The FBI report, which was not completed until after the NASD had approved Wilkowski's registration, revealed that he had pleaded guilty in 1972 to three counts of felony forgery, for which he received a five-year suspended sentence. The NASD immediately sent a copy of the rap sheet to Titan and requested that Titan return to the NASD a written statement from Wilkowski, providing details about the conviction and an explanation of his failure to disclose the information on the registration form.

When Titan asked Wilkowski for an explanation, he responded with a letter explaining that he believed that pursuant to his plea agreement, his forgery conviction would be expunged upon his making restitution of $16,000. Without saying so explicitly, Wilkowski gave the impression that he had in fact made restitution by indicating that he believed the conviction had been removed from his record before he prepared the application for the NASD. Along with this explanation, Wilkowski submitted a new application form, on which he disclosed the forgery conviction. The NASD did not revoke Wilkowski's registration and Titan did not terminate him as a registered

representative. Painter, however, did terminate Wilkowski as a financial counselor.

During the time that Wilkowski worked as a registered representative of Titan, he received funds from appellants to invest. Wilkowski legitimately invested some of the funds in securities through Titan. Sometimes, however, Wilkowski instructed appellants to make the checks payable to him personally, and they complied. Rather than investing these funds, Wilkowski diverted them for his own use. He used Titan stationery to generate bogus receipts and financial statements that indicated that the stolen funds had been used to purchase securities and mutual funds through Titan. Ultimately, Wilkowski's activities were discovered and he was convicted of criminal securities fraud and grand theft.

In this civil action, appellants seek to recover their losses under various antifraud provisions of the federal securities laws and under state law. The district court awarded summary judgment to both Titan and Painter on all of appellants' federal claims and dismissed appellants' pendent state claims.[3] We affirm summary judgment in favor of Painter on all federal claims. We affirm summary judgment in favor of Titan on all federal claims, except three: 1) the claim that Titan is liable for Wilkowski's wrongdoing as a "controlling person" under § 20(a) of the 1934 Act, 15 U.S.C. § 78t(a); 2) the claim that Titan is liable as a "controlling person" under § 15 of the Securities Act of 1933 Act ("1933 Act"), 15 U.S.C. § 77*o*;[4] and 3) the claim that Titan is liable as Wilkowski's

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[3]Appellants obtained a default judgment against Wilkowski, who was also named as a defendant in the civil suit.

[4]The standards for liability as a controlling person under § 15 are not materially different from the standards for determining control-

employer under the common law theory of respondeat superior.

We address appellants' various theories of liability under the federal securities laws in turn. In doing so, we make an independent determination whether appellees were entitled to summary judgment. *Darring v. Kincheloe*, 783 F.2d 874, 876 (9th Cir. 1986). Summary judgment is appropriate if "there is no genuine issue as to any material fact and . . . the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c).

II

A

Appellants claim that Titan is primarily liable under § 10(b) of the 1934 Act and Rule 10b-5 for failing to disclose to investors Wilkowski's prior forgery conviction.[5] Section 10(b) makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78j(b). Rule 10b-5, which implements § 10(b), makes it unlawful:

> (a) to employ any device, scheme, or artifice to defraud,
>
> (b) to make any untrue statement of a material fact, or *to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.*

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ling person liability under § 20(a). *See Buhler v. Audio Leasing Corp.*, 807 F.2d 833, 835 (9th Cir. 1987).

[5]We address appellants' claims against Painter separately. *See infra* Section VI.

17 C.F.R. § 240.10b-5 (emphasis added). Appellants do not contend that Titan employed "any device, scheme or artifice to defraud" the people who invested with Wilkowski; rather, appellants proceed on the theory that Titan should be liable for failing to disclose Wilkowski's prior forgery conviction.

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), the Supreme Court held that scienter is a necessary element in an action for damages under § 10(b) and Rule 10b-5. The Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 194 n.12. The Court adopted the view that the language of § 10(b), in particular the terms "manipulative," "device," and "contrivance," revealed an unambiguous intent on the part of Congress to proscribe only "knowing or intentional misconduct." *Id.* at 197-99; *see also Aaron v. SEC*, 446 U.S. 680, 690 (1980). Although the Court acknowledged that in some areas of the law recklessness is considered to be a form of intentional conduct, the Court reserved the question whether reckless behavior is actionable under § 10(b) and Rule 10b-5. *See* 425 U.S. at 194 n.12.

[1] Our circuit, however, along with ten other circuits,[6] has held that recklessness may satisfy the element of

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[6]*See, e.g., Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1010 (11th Cir. 1985); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982); *Dirks v. SEC*, 681 F.2d 824, 844 & n.27 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983); *Stokes v. Lokken*, 644 F.2d 779, 783 (8th Cir. 1981); *Broad v. Rockwell Int'l Corp.* 642 F.2d 929, 961-62 (5th Cir.) (en banc), *cert. denied*, 454 U.S. 965 (1981); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 193 (3d Cir.), *cert. denied*, 455 U.S. 938 (1981); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979); *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978) (assumed, but not decided, that "recklessness" sufficient);

scienter in a civil action for damages under § 10(b) and Rule 10b-5. *E.g., Kehr v. Smith Barney, Harris Upham & Co.*, 736 F.2d 1283, 1286 (9th Cir. 1984); *Nelson v. Serwold*, 576 F.2d 1332, 1337-38 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978). We continue to adhere to that view.

In our past decisions, we declined to define recklessness; instead, we tried to delineate its contours. We have said that recklessness is a lesser form of intent rather than a greater degree of negligence, *see Vucinich v. Paine, Webber, Jackson & Curtis Inc.*, 739 F.2d 1434, 1435 (9th Cir. 1984) (citations omitted), and that it involves conduct that is "more culpable than mere negligence," but with an intent less culpable than "deliberately and cold-bloodedly . . . conceal[ing] information." *Nelson v. Serwold*, 576 F.2d at 1337. At times, however, we have articulated a standard of recklessness that is not clearly distinguishable from negligence. *See, e.g., Keirnan v. Homeland, Inc.*, 611 F.2d 785, 788 (9th Cir. 1980) (*scienter* requirement satisfied if defendant "had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts although [defendant] could have done so without extraordinary effort"); *see also Burgess v. Premier Corp.*, 727 F.2d 826, 832 (9th Cir. 1984); *Bell v. Cameron Meadows Land Co.*, 669 F.2d 1278, 1283 (9th Cir. 1982).

Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Sunstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

Although the Fourth Circuit has not explicitly found recklessness to be sufficient, district courts in that circuit have so held. *See In re Epic Mortgage Ins. Litigation*, 701 F.Supp. 1192, 1250 (E.D. Va. 1988) (citing cases), *aff'd in part, rev'd in part on other grounds sub nom Foremost Guar. Corp. v. Meritor Sav. Bank*, Nos. 88-3163, 88-3164, 88-3165, 88-3172, slip op. (4th Cir. August 6, 1990).

[2] Today we adopt the standard of recklessness articulated by the Seventh Circuit in *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977),[7] and adhered to, albeit with some variation, by a majority of circuits.[8] In *Sunstrand*, the Seventh Circuit held that "a reckless omission of material facts upon which the plaintiff put justifiable reliance in connection with a sale or purchase of securities is actionable under Section 10(b) as fleshed out by Rule 10b-5." *Id.* at 1044. The *Sunstrand* court quoted with approval a lower court's definition of recklessness in the context of omissions:

> [R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Id. at 1045 (quoting *Franke v. Midwestern Oklahoma Dev. Auth.*, 428 F.Supp. 719, 725 (W.D. Okla. 1976) *vacated on*

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[7]Although the SEC urges us to adopt a standard of recklessness based on the common law of fraud's standard of "conscious indifference," we prefer the *Sunstrand* standard of recklessness, in part because it allows us to bring greater uniformity to the law of the various circuits.

[8]*See, e.g., Hackbart v. Holmes*, 675 F.2d 1114, 1118 (10th Cir. 1982); *SEC v. Carriba Air, Inc.*, 681 F.2d 1318, 1324 (11th Cir. 1982); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961-62 (5th Cir.) *cert. denied*, 454 U.S. 965 (1981); *McLean v. Alexander*, 599 F.2d 1190, 1197-98 (3d Cir. 1979); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46-47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).

other grounds, 619 F.2d 856 (10th Cir. 1980)). The *Sunstrand* court went on to explain that "the danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing, and the omission must derive from something more egregious than even 'white heart/empty head' good faith." *Id.* (footnotes omitted); *accord Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978) (Reckless conduct is conduct that is "highly unreasonable" and represents "an extreme departure from the standards of ordinary care . . . to the extent that the . . . defendant must have been aware of it.") (quoting *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977)).

[3] In adopting the *Sunstrand* standard of recklessness, we put to rest the "flexible duty standard"[9] announced in *White v. Abrams*, 495 F.2d 724, 735-36 (9th Cir. 1974). As noted by Judge Ferguson in his special concurrence in *Spectrum Fin. Cos. v. Marconsult, Inc.*, 608 F.2d 377, 382 (9th Cir. 1979) (Ferguson, J., concurring), *cert. denied*, 446 U.S. 936 (1980), the flexible duty test was expressly disapproved in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), because it is essentially a negligence standard. Even after the Supreme Court had rejected

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[9]The "flexible duty" test required courts to consider the following factors:

> (1) the relationship of defendant to plaintiff; (2) defendant's access to the information as compared to that of plaintiff; (3) defendant's benefit derived from the relationship; (4) defendant's awareness of whether plaintiff was relying on their relationship in making his or her investment decisions; and (5) defendant's activity in initiating the transaction in question.

Zweig v. Hearst Corp., 594 F.2d 1261, 1268 (9th Cir. 1979) (paraphrasing *White*, 495 F.2d at 735-36).

White's flexible duty test, *see* 425 U.S. at 193 n.12,[10] the test continued to resurface in our cases.[11] But as Judge Ferguson rightly pointed out, the flexible duty test is a negligence test "designed to compartmentalize and simplify a negligence inquiry," *Spectrum*, 608 F.2d at 385, and *Hochfelder* rejected negligence in favor of a scienter requirement.

In applying the *Sunstrand* test to the facts of this case,[12] the essential inquiry becomes: Was Titan's failure to disclose Wilkowski's eleven-year old forgery conviction highly unreasonable and did it constitute an extreme departure from standards of ordinary care?

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[10]As Judge Ferguson pointed out in his concurring opinion in *Spectrum*, the Supreme Court listed the *White* decision "as an example of the negligence standard it was repudiating." *Spectrum*, 608 F.2d at 383.

[11]*See, e.g., Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273, 1294 (9th Cir. 1979); *Zweig*, 594 F.2d at 1268 n.13; *Crocker-Citizens Nat'l Bank v. Control Metals Corp.*, 566 F.2d 631, 636 n.2 (9th Cir. 1977).

[12]The parties dispute whether Titan's failure to disclose Wilkowski's forgery conviction is a material fact. The district court held that the omission was not material. We find it arguable, however, that a reasonable investor would consider this information important to her decision to do business with a registered representative. *See SEC v. Rogers*, 790 F.2d 1450, 1458 (9th Cir. 1986) (Information is material "if 'there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision.' ") (quoting *Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, 769 F.2d 561, 565 (9th Cir. 1985)). Therefore, we will assume, without deciding, that a jury could reasonably find the omission to be material, and we will go on to decide whether Titan acted with scienter.

B

We start our inquiry by considering what Titan did know. In February, 1984, less than a month after the NASD had registered Wilkowski as a securities salesman, Titan learned from the NASD that Wilkowski had failed to disclose a prior conviction on his application. When Titan received Wilkowski's rap sheet, it learned that eleven years earlier Wilkowski had received a suspended five-year sentence for felony forgery. When Titan asked Wilkowski to explain, Wilkowski gave what appeared on its face to be a plausible explanation:[13] that he believed that his record had been expunged after five years under the terms of his plea agreement.[14]

Titan also knew the NASD, after reviewing all the information that Titan had on Wilkowski, decided not to revoke his registration as a registered representative.

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[13]Wilkowski's letter said in relevant part:

> In the proceedings there was a plea bargaining situation which reduced my situation to a count of forgery to which I plead [sic] guilty. After negotiating the situation, and a presentencing report had been entered, I was placed upon probation, provided I made restitution of $16,843.49. At the time restitution was completed, the court was to be petitioned to remove the guilty plea thus removing the record of this ever having occurred. At that time, I could actually state that I had not been convicted of any of the above.
>
> . . . .
>
> I was under the mistaken impression the matter was removed — which obviously is not the case.

Record Excerpts ("R.E.") at 321-22.

[14]There is no evidence that at the time of Wilkowski's defalcations, Titan knew that Wilkowski had failed to make the restitution required by the plea agreement.

Titan was also aware that the NASD had not imposed any restriction or conditions on Wilkowski's license to sell securities, although it was within its power to do so.

Titan further knew that an eleven-year old forgery conviction was not considered disqualifying by either Congress or the NASD for purposes of determining whether a person should be licensed to work as a salesperson in the securities industry. As part of the 1934 Act, Congress provided that any person who met all of the requirements imposed by the NASD and who was not statutorily disqualified could be registered without restrictions as a representative of a broker-dealer to sell securities. *See* 15 U.S.C. § 78*o*(b)(1). Congress expressly provided that a forgery conviction was a statutory disqualification only if it occurred within ten years preceding the application registration. 15 U.S.C. § 78*o*(b)(4)(B)(iii). Under its rules, the NASD will give an unconditional registration to an applicant who is not statutorily disqualified and who "passes the applicable qualification examination, provides all necessary information and pays all required fees." Aff't of Andrew McR. Barnes, Associate General Council of the NASD, Clerk's Record ("C.R.") 80:1. The NASD may either refuse to register a person who is subject to statutory disqualification or impose special conditions on the registration. *Id.* at 80:3. Such conditional registrations typically require the sponsoring broker-dealer to engage in increased supervision of the registered representative's work. *Id.* at 80:3. Wilkowski, who was not subject to a statutory disqualification, was granted an unconditional registration. Although the NASD's unconditional registration did not mean that it had certified Wilkowski to be a trustwor-

thy securities salesman,[15] the fact that Wilkowski was registered unconditionally and that the registration was neither revoked nor conditioned after the forgery conviction surfaced is relevant to the question of whether Titan acted recklessly when it omitted to inform appellants of the conviction.

[4] On the record, we hold that appellants have failed to make "a showing sufficient to establish the existence of an element essential to [their] case, and on which [they] will bear the burden of proof at trial." *See Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986). When we view Wilkowski's conviction in light of Congress' decision not to make an eleven-year old forgery conviction a statutory disqualification and the NASD's decision not to revoke or condition Wilkowski's registration, we conclude that the evidence would be insufficient to support a finding of fact that the conviction created a highly unreasonable risk that should have been obvious to Titan. A broker-dealer is

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[15] We do not agree with appellants that Barnes' affidavit supports their contention that Titan had a duty to disclose Wilkowski's forgery conviction to his clients. Barnes merely explained in his affidavit that the fact that the NASD had given Wilkowski an unconditional registration did not settle the question of whether Titan should have disclosed the conviction. C.R. 80:3. Barnes asserts that by registering Wilkowski, the NASD did not represent to Titan or to the public that Titan "should have hired Wilkowski . . . or [that] Titan [need not] have told the customers about Wilkowski's conviction." *Id.* at 80:3. Instead, under the NASD's Rules of Fair Practice, to which all broker-dealers subscribe, "[f]inal responsibility for proper supervision . . rest[s] with the member." *Id.* at 80:2. We agree that the NASD's decision to give Wilkowski an unconditional registration did not mean that the NASD approved of Titan's decision not to disclose the conviction. Nonetheless, as we discuss in the text, the NASD's decision to register Wilkowski without placing any supervision or other conditions on his registration tends to undermine appellants' argument that Titan acted recklessly.

not required to inform investors of every negative fact it knows about its registered representatives. It is a matter of judgment whether the negative facts create such a highly unreasonable risk of untrustworthiness that it would constitute recklessness. Here, we conclude that Titan's failure to disclose Wilkowski's eleven-year old conviction did not create such an unreasonable risk to investors that Titan's failure to disclose the conviction was an extreme departure from the standard of ordinary care.

In the final analysis, Titan may have made an error in judgment in failing to disclose Wilkowski's conviction to his clients. Indeed, it is arguable that a fair-minded jury might reasonably find that the failure to disclose the conviction constituted negligence. But in our view, a fair-minded jury could not find that Titan acted recklessly under the *Sunstrand* standard that we adopt today. Thus, we hold that appellants have failed to raise a triable issue of fact as to their claim that Titan acted with the requisite scienter under § 10(b) and Rule 10b-5.

[5] Appellants also claim that Titan should be primarily liable under § 10(b) and Rule 10b-5 for failing to inform them that Wilkowski had not made full restitution as of March 1984 to the individuals he had defrauded, although the terms of his plea agreement required restitution to be made by 1977. We also reject this claim. The only evidence that appellants point to is Wilkowski's letter to Titan and the NASD, in which he explained his understanding of the plea agreement. *See* R.E. at 321-22. Even when we view that document in the light most favorable to appellants, we do not believe that a fair-minded jury could infer from it that Titan knew that Wilkowski had not made restitution. Thus, appellants have failed to raise a triable issue as to their claim that

Titan knew that Wilkowski had failed to make full restitution as of March 1984.

In sum, we affirm the district court's order granting Titan summary judgment on appellants' § 10(b) and Rule 10b-5 claim.

III

We next consider whether Titan can be held vicariously liable as a "controlling person" under § 20(a) of the 1934 Act for Wilkowski's violations of the securities laws. Section 20(a) provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a).

To hold Titan liable under § 20(a), appellants must first establish that Titan was a "controlling person" within the meaning of the statute.[16]

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[16]The SEC has defined "control" to mean:

> [T]he possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract, or otherwise.

17 C.F.R. § 230.405.

The district court interpreted the law of this circuit as requiring appellants to prove that Titan exercised "actual power or influence" over Wilkowski's fraudulent dealings and that Titan was a "culpable participant" in the alleged illegal activity in order to establish that Titan was a "controlling person" for the purpose of § 20(a). R.E. at 32 (citing *Buhler*, 807 F.2d at 835). The district court, after applying this test, granted Titan summary judgment on appellants' § 20(a) claim. First, the court reasoned that Titan had no "power or influence" over Wilkowski because Wilkowski was an independent contractor and Titan did not exercise any control over Wilkowski's defalcation of funds; did not benefit from the defalcation of funds; and did not authorize Wilkowski to receive personal checks. *See id.* Second, the court concluded that because Titan and Wilkowski had contractually agreed that Wilkowski would be an independent contractor, Titan had no duty to supervise unauthorized and unknown transactions and therefore could not have been a "culpable participant" in Wilkowski's misdeeds. *See id.* at 34. In applying the language in *Buhler*, the District Court made the question of whether Titan controlled Wilkowski turn on the particular business arrangement of the parties.

A

[6] The SEC, as amicus curiae, joins appellants in arguing that the district court erred in holding that Titan could not be held vicariously liable as a "controlling person" under § 20(a) for Wilkowski's misdeeds. We agree. Today we hold that a broker-dealer is a controlling person under § 20(a) with respect to its registered representatives.

First, the SEC notes that this circuit and other circuits have interpreted the securities laws to impose a duty on

broker-dealers to supervise their registered representatives.[17] In *Zweig*, we noted that Congress adopted § 20(a) in an attempt to protect the investing public from representatives who were inadequately supervised or controlled:

> Purchasers of securities frequently rely heavily for investment advice on the broker-representative handling the purchaser's portfolio. Such representatives traditionally are compensated by commissions in direct proportion to sales. The opportunity and temptation to take advantage of the client is ever present. To ensure the diligence of supervision and control, the broker-dealer is held vicariously liable if the representative injures the investor through violations of Section 10(b) or the rules thereunder promulgated. The very nature of the vast securities business, as it has developed in this country, militates for such a rule as public policy and would seem to suggest strict court enforcement.

521 F.2d at 1135.

The SEC argues that the representative/broker-dealer relationship is necessarily one of controlled and controlling person because the broker-dealer is required to supervise its representatives. This requirement arises from § 15 of the 1934 Act,[18] which the SEC has interpreted as

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[17] *See, e.g., Zweig v. Hearst Corp.*, 521 F.2d 1129, 1134-35 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); *accord Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1120 (5th Cir. 1980); *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

[18] Section 15(b)(4) provides:

> The Commission, by order, shall censure, place limitations on . . . , suspend . . . or revoke the registration of any broker or

authority to impose sanctions on broker-dealers who have failed to provide adequate supervision of their registered representatives. *See, e.g., In re Reynolds & Co.*, 39 S.E.C. 902, 916-17 (1960); *In re Bond & Goodwin, Inc.*, 15 S.E.C. 584, 601 (1944).

Second, the SEC argues that as a practical matter the broker-dealer exercises control over its registered representatives because the representatives need the broker-dealer to gain access to the securities markets. Again, the SEC points to § 15(a) of the 1934 Act, which provides that a person cannot lawfully engage in the securities business unless he or she is either registered with the NASD as a broker-dealer or as a person associated with a broker-dealer.[19] Because a sales representative must be associated with a registered broker-dealer in order to have legal access to the trading markets, the broker-dealer always has the power to impose conditions upon that association, or to terminate it. The broker-dealer's ability to deny the representative access to the markets gives the broker-dealer effective control over the representative at the most basic level. Moreover, because the broker-dealer is required by statute to establish and enforce a reasonable system of supervision to control its

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dealer if it finds . . . that such broker or dealer . . . (E) . . . has failed reasonably to supervise, with a view to preventing violations . . . [of the securities laws], another person who . . . is subject to his supervision.

15 U.S.C. § 78*o*(b)(4).

[19]Section 15(a) of the 1934 Act provides:

(1) it shall be unlawful for any . . . person not associated with a [registered] broker or dealer . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in . . . any security.

15 U.S.C. § 78*o*(a).

representatives' activities,[20] the broker-dealer necessarily exerts ongoing control over the types of transactions made by the representative and her ways of handling clients' accounts.

In contrast to the SEC's position, the district court's reasoning implied that even if Titan had the power to deny Wilkowski access to the trading markets or was required by statute to supervise his securities transactions, Titan still should not be considered a controlling person under § 20(a) because Wilkowski was an independent contractor, not an agent.[21] We find no support in the statutory scheme for such a restrictive definition of controlling person that would exclude independent contractors, and thus, we do not distinguish for purposes of § 20(a) between registered representatives who are employees or agents and those who might meet the definition of independent contractors.

[7] In sum, § 20(a) of the Act provides that a person cannot lawfully engage in the securities business unless he is either registered as or associated with a broker-dealer, and we see no basis in the statutory scheme to distinguish between those associated persons who are employees and agents on the one hand, and those who are independent contractors on the other. To exclude from

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[20]Section 15(b) of the 1934 Act defines reasonable supervision as:

> established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any . . . violation [of the Act] by [an associated person].

15 U.S.C. § 78*o*(b)(4)(E)(i).

[21]This argument was never advanced by Titan. Titan acknowledged a duty to supervise Wilkowski and argued that its supervision of him was adequate.

the definition of controlling person those registered representatives who might technically be called independent contractors would be an unduly restrictive reading of the statute and would tend to frustrate Congress' goal of protecting investors. Thus, we reject the argument that broker-dealers can avoid a duty to supervise simply by entering into a contract that purports to make the representative, who is not himself registered under the Act as a broker-dealer, an "independent contractor."[22]

To summarize, we hold that a broker-dealer is a controlling person under § 20(a) with respect to its registered representatives. This result is consistent with *Zweig,* where we said that "[t]o ensure the diligence of supervision and control, the broker-dealer is held vicariously liable if the representative injures the investor through violations of Section 10(b) or the rules thereunder promulgated." 521 F.2d at 1135. Thus, for appellants to establish that Titan was a controlling person, they need only show that Wilkowski was not himself a registered broker-dealer but was a representative employed by or associated with a registered broker-dealer. This they have done. The facts are not in dispute that Wilkowski was a registered representative associated with Titan. Accord-

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[22]The contract between Titan and Wilkowski provided:

> 7. *Contractor's Freedom from Company Controls.* The Company has no right to control or direct the Contractor in the sales of securities, not only as to the result to be accomplished by the work but also as to the details and means by which the result is accomplished, excepting [oversight and instructions required to comply with securities laws.] . . . . [The Contractor is completely free from the will and control of the Company not only as to what shall be done, but how it shall be done.

R.E. at 311-12.

ingly, Titan was, as a matter of law, a "controlling person" under § 20(a) with respect to Wilkowski.

Titan also argues that it was not a controlling person because it was not a "culpable participant" in Wilkowski's deeds as required by *Buhler*, 807 F.2d at 835-36, and *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 668-69 (9th Cir. 1978).

The district court, citing earler cases from our circuit, agreed with Titan and ruled that a broker-dealer is not a "controlling person" under § 20(a) unless the plaintiff proves that the broker-dealer was a "culpable participant" in the violation.[23]

[8] Today, however, we hold that a plaintiff is *not* required to show "culpable participation" to establish that a broker-dealer was a controlling person under § 20(a).[24] The statute does not place such a burden on the plaintiff. Section 20(a) provides that a "controlling person" is liable "unless [he] acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a). Thus, the statute premises liability solely on the control relationship, subject to the good faith defense. According to the statutory language, once the plaintiff establishes that

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[23]*See Buhler*, 807 F.2d at 835-36; *Kersh v. General Council of Assemblies of God*, 804 F.2d 546, 549-50 (9th Cir. 1986); *see also Christoffel*, 588 F.2d at 669 (adopting "participation" requirement, but not "culpable participation" requirement).

[24]Today's holding, however, is reached in the context of the broker-dealer/registered representative relationship exclusively. We do not address the question of whether in other contexts the first prong of the *Buhler* and *Christoffel* test for determining a "controlling person," namely that of power and influence, may be applied. A person may, of course, be a controlling person without being a broker-dealer. *See, e.g., Zweig*, 521 F.2d at 1132.

the defendant is a "controlling person," then the defendant bears the burden of proof to show his good faith.[25]

Today we return to what had once been the law of our circuit, namely that § 20(a) requires the defendant to prove his good faith. In *Safeway Portland Employees' Federal Credit Union v. C.H. Wagner & Co., Inc.*, 501 F.2d 1120, 1124 (9th Cir. 1974), in discussing the analogous controlling person provision of the 1933 Act, we had said that "[t]hose claiming the exemption have the burden of proving it." In *Buhler, Kersh,* and *Christoffel,* however, we placed on the plaintiff the burden of disproving the defendant's good faith. In *Orloff v. Allman,* 819 F.2d 904, 906 n. 1 (9th Cir. 1987), we noted the shift: "*Buhler* and *Kersh II* rely upon *Christoffel v. E.F. Hutton & Co.* . . . , which overlooked prior circuit law." Now, we make clear that in an action based on § 20(a), the defendant who is a controlling person, and not the plaintiff, bears the burden of proof as to defendant's good faith. Thus, a plaintiff need not make a showing as to defendant's culpable participation; rather, a defendant has the burden of pleading and proving his good faith.

[9] To summarize, a broker-dealer controls a registered representative for the purposes of § 20(a). By recognizing this control relationship, we do not mean that a broker-dealer is vicariously liable under § 20(a) for all

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[25]We join several other circuits in holding that the defendant bears the burden of proving his good faith. *See, e.g., Paul F. Newton & Co. v. Texas Commerce Bank,* 630 F.2d 1111, 1120 (5th Cir. 1980); *Marbury Management, Inc. v. Kohn,* 629 F.2d 705, 716 (2d Cir.), *cert. denied,* 449 U.S. 1011 (1980); *SEC v. Savoy Industries, Inc.,* 587 F.2d 1149, 1170 (D.C. Cir. 1978), *cert. denied,* 440 U.S. 913 (1979); *Fey v. Walston & Co., Inc.,* 493 F.2d 1036, 1051-52 (7th Cir. 1974); *Mader v. Armel,* 461 F.2d 1123, 1126 (6th Cir.), *cert. denied,* 409 U.S. 1023 (1972).

actions taken by its registered representatives. Nor are we making the broker-dealer the "insurer" of its representatives, which is a result we rejected in *Christoffel* as going beyond the scope of the vicarious liability imposed upon a broker-dealer by § 20(a). The mere fact that a controlling person relationship exists does not mean that vicarous liability necessarily follows. Section 20(a) provides that the "controlling person" can avoid liability if she acted in good faith and did not directly or indirectly induce the violations. By making the good faith defense available to controlling persons, Congress was able to avoid what it deemed to be an undesirable result, namely that of insurer's liability, and instead it made vicarious liability under § 20(a) dependent upon the broker-dealer's good faith.[26]

C

[10] Contrary to the district court's ruling, the broker-dealer cannot satisfy its burden of proving good faith merely by saying that it has supervisory procedures in place, and therefore, it has fulfilled its duty to supervise. A broker-dealer can establish the good faith defense only by proving that it "maintained and enforced a reasonable and proper system of supervision and internal control." *Zweig,* 521 F.2d at 1134-35; *see also Paul F. Newton & Co.,* 630 F.2d at 1120 (broker-dealer must show it "diligently

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[26] The broker-dealer may also, of course, rely on a contention that the representative was acting outside of the broker-dealer's statutory "control." For example, Titan could argue that when appellants entrusted their money to Wilkowski they were not reasonably relying upon him as a registered representative of Titan, but were placing the money with Wilkowski for purposes other than investment in markets to which Wilkowski had access only by reason of his relationship with broker-dealer Titan.

enforce[d] a proper system of supervision and control"). Accordingly, the district court erred in ruling that because "Titan had adopted rules for accepting investment payments and for supervising a contractor's compliance with securities laws and regulations," it had satisfied its duty to supervise. R.E. at 34. Should Titan choose to rely upon the good faith defense, then it must carry its burden of persuasion that its supervisory system was adequate and that it reasonably discharged its responsibilities under the system. The evidence below raised material issues of fact as to whether Titan's supervision of Wilkowski was sufficient to entitle Titan to the good faith defense. Summary judgment was, accordingly, improper.

IV

Appellants also claim on appeal that the district court erred in granting summary judgment to Titan on appellants' claim that Titan was secondarily liable for Wilkowski's § 10(b) violation under the common law theory of respondeat superior. Although it has been the law of our circuit that § 20(a) "supplants vicarious liability of an employer for the acts of an employee applying the respondeat superior doctrine," *Christoffel*, 588 F.2d at 667 (citing *Zweig*, 521 F.2d at 1132-33; *Kamen & Co. v. Paul H. Aschkar & Co.*, 382 F.2d 689, 697 (9th Cir. 1967), *cert. dismissed*, 393 U.S. 801 (1968)); *see also Buhler*, 807 F.2d at 835 n. 4 ("we continue to adhere to our prior holdings that the common law is supplanted by sections 15 and 20"), we now join several other circuits[27] in holding that

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[27] *See, e.g., In re Atlantic Fin. Management, Inc.*, 784 F.2d 29, 32-34 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987); *Commerford v. Olson*, 794 F.2d 1319, 1322-23 (8th Cir. 1986); *Marbury Management*, 629 F.2d at 712-16 (2d Cir.); *Paul F. Newton & Co.*, 630 F.2d at 1115-19 (5th Cir.); *Holloway v. Howerdd*, 536 F.2d 690, 694-95

§ 20(a) was intended to supplement, and not to supplant, the common law theory of respondent superior as a basis for vicarious liability in securities cases.[28]

(6th Cir. 1976); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 740-41 (10th Cir. 1974).

The Third Circuit has held that respondent superior "should not be widely expanded in the area of federal securities regulation," but that it should be available against broker-dealers and accounting firms in view of "the public trust of the firms involved, and the duty to supervise arising therefrom." *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 182-83 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *see also Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 884-86 (3d Cir. 1975).

The Fourth Circuit law is in a state of confusion. *Compare Carras v. Burns*, 516 F.2d 251 (4th Cir. 1975) *with Carpenter v. Harris, Upham & Co.*, 594 F.2d 388 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). One district court thinks that *Carpenter* overruled *Carras sub silentio*. *Haynes v. Anderson & Strudwick, Inc.*, 508 F.Supp. 1303, 1311 (E.D. Va. 1981). Two other district courts, disagreeing, distinguished *Carpenter* and continued to follow *Carras*. *Frankel v. Wyllie & Thornhill, Inc.*, 537 F.Supp. 730, 740-42 (W.D. Va. 1982); *Baker v. Wheat First Securities*, 643 F.Supp. 1420, 1425-27 (S.D.W.Va. 1986).

The Seventh, Eleventh, and District of Columbia Circuits have not directly spoken to the issue.

Although the dissent suggests that the Sixth Circuit in *Holloway v. Howerdd* did not apply respondeat superior to federal causes of action, but only to state law causes of action, there is no mention of any state law cause of action in that case. *Holloway v. Howerdd*, 536 F.2d at 692. The district court decision, which the *Holloway* court affirmed, explicitly applied respondeat superior to a § 12(2) claim. *Id.* at 694 (the district court held that the "liability of TSI under § 12(2) was predicated upon the doctrine of respondeat superior"). Significantly, *Holloway* explicitly disagreed with the Ninth Circuit authority we overrule today. *Id.* at 695.

[28]Respondeat superior is a common law principle of secondary liability and generally "summarizes the doctrine that a master or other principal is responsible, under certain conditions, for the conduct of a servant or other agent." Seavey, *Speculations as to*

In our earlier cases, we had concluded, without much explanation, that § 20(a) supplanted the doctrine of respondeat superior. For example, in *Kamen*, 382 F.2d at 697, we concluded that cases relying on respondeat superior had "no application to actions maintained under the Securities Acts." Then, in *Zweig*, 521 F.2d at 1132-33, we cited with approval our earlier decision in *Kamen*, in which we had rejected "[t]he contention that the more stringent doctine of *respondeat superior* remained effective to establish vicarious liability." *Id.* at 1132. With no further explanation, we noted that "[t]the *Kamen* rule is well established in this circuit" and that "*Kamen* provides the controlling authority in [the *Zweig*] appeal." *Id.* More recently, in *Christoffel*, we reaffirmed, without elaboration, that it was "the established law of this circuit that section 20(a) supplants vicarious liability of an employer for the acts of an employee applying the respondeat superior doctrine." 588 F.2d at 667. In *Buhler*, 807 F.2d at 835 n. 4, we held that we would continue to abide by our prior holdings that "the common law is supplanted by sections 15 and 20." The only explanation we offered at the time was that "the securities laws in general were meant to impose liability only on culpable parties with enforceable control." *Id.*[29]

"Respondeat Superior," Harv. Legal Essays 433(1934). A common application of this doctrine is the liability of an employer for a tort committed by one of its employees acting within the scope of his employment, or for a misleading statement made by an employee or other agent who has actual or apparent authority. *See Restatement (Second) of Agency* §§ 219, 257, 261 (1958).

[29]*See* Comment, *Rule 10b-5 and Vicarious Liability Based on Respondeat Superior*, 69 Calif. L. Rev. 1513, 1519 (1981) ("[T]he exclusivity view of Section 20(a) is firmly entrenched in the law of the Ninth Circuit, yet the Court of Appeals for the Ninth Circuit has never discussed any reasoning for or against that view.").

[11] After reexamination of the issue as an en banc court, we are now satisfied that "the 'controlling person' provision of Section 20(a) was not intended to supplant the application of agency principles in securities cases, and that it was enacted to expand rather than to restrict the scope of liability under the securities laws." *Marbury Management*, 629 F.2d at 712; *accord Paul F. Newton & Co.*, 630 F.2d at 1118 (The legislative "history does not reflect any congressional intent to restrict secondary liability for violations of the acts to the controlled persons formula.").

Section 20(a), which was modelled after the controlling person provision of § 15 of the Securities Act of 1933, 15 U.S.C. § 77*o*, was intended "to prevent evasion" of the law "by organizing dummies who will undertake the actual things forbidden."[30] In other words, § 20(a) was intended to impose liability on controlling persons, such as controlling shareholders and corporate officers, who would not be liable under respondeat superior because they were not the actual employers. Thus, in enacting § 20(a), Congress expanded upon the common law, and in doing so, created a defense (the good faith defense) that would be available only to those who, under common law principles of respondeat superior, would have faced no liability at all.

Only if both respondeat superior and § 20(a) are available is the statutory scheme comprehensive and the public protected by the federal securities laws. "To allow a brokerage firm to avoid secondary liability simply by

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[30] *Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.) Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 6571 (1934) (statement of Thomas G. Corcoran, in the office of counsel for the Reconstruction Finance Corporation and one of the drafters of the Securities Act of 1934).

showing ignorance, purposeful or negligent, of the acts of its registered representative contravenes Congress' intent to protect the public, particularly unsophisticated investors, from fraudulent practices." *Paul F. Newton & Co.*, 630 F.2d at 1118-19. When both remedies are available, then the agent who personally committed the wrong is primarily liable (based on proof of his actions or omissions, and on scienter when required); the principal who acts through the agent (assuming the agent is acting within the scope of his agency) is secondarily liable; and other persons who are not subject to respondeat superior but who nevertheless control the wrongdoer can be held liable under § 20(a). Because the liability of persons under § 20(a) represents an extension of liability, beyond that imposed by the common law, such persons are afforded statutory defenses not available in the principal-agent context. Controlling persons may thus avoid liability under § 20(a) by demonstrating that they acted in "good faith" within the meaning of that section.

[12] Whether appellants will ultimately be able to hold Titan liable under either § 20(a) or respondeat superior depends on issues to be resolved on remand.[31] All that we hold today is that the district court erred in granting summary judgment to Titan on appellants' § 20(a) claim, *see* text, *supra*, at ___, and that in light of today's decision, the district court erred in concluding that "[t]he established law of the Ninth Circuit is that section 20(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78t(a)) and section 15 of the Securities Act of 1933 (15 U.S.C. § 77*o*) supplant[ ] the doctrine of respondeat superior." R.E. at 31. Rather, appellants may proceed on their theories of

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[31]We express no opinion on the question of whether Wilkowski is an independent contractor for respondeat superior purposes. That question turns on issues of fact to be resolved on remand.

liability based on both § 20(a) and respondeat superior because it is no longer the law of this circuit that the former supplants the latter.

V

We now turn to appellants' remaining claims against Titan under federal securities laws.

[13] We reverse the district court's order granting summary judgment to Titan on appellants' claim that Titan is secondarily liable under § 15 of the 1933 Act, 15 U.S.C. § 77*o*, for Wilkowski's violations of § 12(2).[32] The district court reasoned that Titan was not a "controlling person" under § 15, and thus, could not be held vicariously liable for Wilkowski's violations of the 1933 Act. We disagree. Although § 15 is not identical to § 20(a), the controlling person analysis is the same. *See Buhler,* 807 F.2d at 835. Because we hold that Titan is a controlling person as a matter of law under § 20(a), we also hold that it is a controlling person under § 15. Titan has, of course, the same good faith defense available to it under § 15 as it has under § 20(a). *See* Part III-B, *supra.*

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[32]Section 15 of the 1933 Act provides in relevant part:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under [Section 12(2)], shall also be liable jointly and severally with and to the same extent as such controlled person . . . , unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77*o*.

Next, we affirm the district court's order granting summary judgment to Titan on appellants' claims under § 15 of the 1934 Act, 15 U.S.C. § 78*o*, because this section does not give rise to a private right of action. *See SEC v. Seaboard Corp.*, 677 F.2d 1301, 1313-14 (9th Cir. 1982). We also hold that the claims under § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a), fail for the same reason. *See In re Washington Public Power Supply Sys. Securities Litigation*, 823 F.2d 1349, 1354-55 (9th Cir. 1987) (en banc).

Finally, we affirm the district court's order granting summary judgment to Titan on appellants' claim that Titan was primarily liable under § 12(2) of the 1933 Act, 15 U.S.C. § 77*l*, because appellants abandoned that claim before the district court. *See* R.E. at 36.

VI

We address appellants' claims against Painter separately. The character and basis of plaintiffs-appellants' claims against Painter were murky in the district court and remain so on appeal. Basically, appellants contend that Painter is liable under the same statutes and for the same reasons that Titan is because Painter employed Wilkowski, the fraud was committed in Painter's office, a Painter employee reviewed orders for securities sales before forwarding the paperwork to Titan, and Painter held "open houses" at which Painter's clientele were introduced to Wilkowski and the securities business. Thus, appellants contend, Painter is liable *as though it were a broker-dealer.*

[14] We affirm summary judgment in favor of Painter on appellants' federal securities claims based on §§ 10(b) and 15 of the 1934 Act and on § 17(a) of the 1933 Act. With respect to appellants' claims attempting to hold Painter vicariously liable under § 20(a) of the 1934 Act

and § 15 of the 1933 Act, the district court properly granted summary judgment to Painter. Painter is not a registered broker-dealer, nor does it engage in the sale of securities. Accordingly, Painter cannot be considered a controlling person under our analysis in Part III above. Appellants have cited no evidence that Painter exercised actual "power and influence" over Wilkowski's actions in embezzling funds. Thus, we hold that appellants have failed to raise a triable issue of material fact under either § 20(a) or § 15.[33]

CONCLUSION

We AFFIRM the district court's order granting summary judgment in favor of Painter on all federal claims and dismissing all state law claims against Painter. We AFFIRM summary judgment as to Titan on all federal claims except for appellants' claims that Titan is secondarily liable under § 20(a), § 15, and respondeat superior for Wilkowski's violations of federal securities laws. Accordingly, we VACATE the district court's order dismissing pendent state claims against Titan.[34]

HALL, Circuit Judge with whom RYMER, Circuit Judge, joins dissenting:

I concur in all but section IV of the majority opinion. I would hold that section 20(a) of the Act, which already imposes vicarious liability upon all employers for the

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[33]Appellants did not appear to raise nor did the district court address the question of Painter's alleged liability under a theory of respondeat superior, and therefore, we do not reach the question at this time.

[34]Appellees' request for attorney's fees on appeal is denied. This appeal plainly cannot be characterized as frivolous within the meaning of Fed.R.App. P. 38.

fraudulent acts of their employees, precludes the grafting of the common law doctrine of respondeat superior onto a federal securities law action. The inclusion in the securities laws of statutory provisions which expressly impose controlling person liability indicates that Congress intended to exclude other forms of vicarious liability. If we impose secondary liability under respondeat superior upon Titan for Wilkowski's rule 10b-5 fraud, we effectively nullify the exculpatory provision of section 20(a) as well as the scienter element of a 10(b) claim. The majority bases its holding on an analysis of the legislative history behind section 20(a) and on policy arguments regarding the remedial nature of the Act. *Majority opinion* at 13935-36. Both of these arguments are unpersuasive for a number of reasons.

A more comprehensive examination of the legislative history behind section 20(a) reveals the majority's conclusion to be somewhat facile. While preventing "dummy" corporations from escaping liability under the Act may have been one reason for the enactment of section 20(a) (*see majority opinion* at 13935),[1] its primary purpose was

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[1]It also appears that the remarks regarding "organizational dummies" were primarily addressed to section 20(b), not section 20(a). The former section provides:

> It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this title or any rule or regulation thereunder through or by means of any other person.

Securities Exchange Act of 1934 § 20(b), 15 U.S.C. § 78(b) (1976).

When referring to the two sections, the report of the Committee on Interstate Commerce stated that section 20(a) makes "a person who controls a person . . . liable to the same extent as the person controlled unless the controlling person acted in good faith and did not induce the act in question." 78 Cong. Rec. 7709 (1934). In discussing

to limit securities fraud liability to those whose conduct is in some sense culpable. Section 20(a) was modeled upon section 15 of the Securities and Exchange Act of 1933.[2] Hearings on S. Res. 84 (72d Cong.), S. Res. 56 and 97 (73d Cong.) Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. 6571 (1934). Section 15 originally made controlling persons liable under Securities Act section 11 (imposing liability for untrue or misleading statements in a registration statement on issuer, underwriter and others involved with the registration statement) and section 12 (imposing liability on sellers of unregistered securities or of securities sold by means of untrue or misleading statements) jointly and

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section 20(b), the Committee noted that that section "makes it unlawful for any person to do, through any other person, anything that he is forbidden to do himself." *Id.*

[2]Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t(a) (1976) provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Securities Exchange Act of 1933 § 15, as amended, 15 U.S.C. § 77o (1976) provides:

> Every person who, by or through stock ownership, agency, or otherwise . . . controls any person liable under section 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

severally with the controlled person to anyone to whom the controlled person was liable. 1933 Act, ch. 38, § 15, 48 Stat. 84. Congress specifically rejected the notion of insurer liability under this 1933 Act. As we noted in *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 668 (9th Cir. 1978):

> Legislative history reveals that the Senate and the House had advocated different versions of the standard that should govern controlling persons. The House proposed that the standard should be a "fiduciary standard," which would require a duty of due care. (H.R. Rep. No. 85, 73d Cong., 1st Sess. 27 (1933); H.R. Rep. No. 152, 73d Cong., 1st Sess. 27 (1933).) On the other hand, the Senate proposed an "insurer's liability" (S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933), the Fletcher Report). Congress enacted the House version, rejecting the insurer concept.

Id. at 668.[3]

Furthermore, the comments to section 20(a) made by Representative Rayburn, the then-Chairman of the House Committee on Interstate and Foreign Commerce, show that employers were meant to fall within that section, and

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[3]Congress made the good-faith defense even more clear one year later. The Act which enacted the 1934 Act amended Section 15 of the 1933 Act by adding the clause at the end reading "unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." H.R. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 42 (1934). *See infra*, n. 3. As Senator Fletcher explained, "the purpose of this amendment is to restrict the scope of the section so as more accurately to carry out its real purpose. The mere existence of control is not made a basis for liability unless that control is effectively exercised to bring about the action upon which liability is based." 78 Cong. Rec. 8185 (1934).

thus be given the protection of the good faith defense. Rep. Rayburn's statement, contained in both the House Report and made on the floor of the House, includes "agency" among other forms of legal relationships under the rubric "control."[4] *See generally* D. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Cal.L.Rev. 80 (1981) for an in-depth review of the legislative history behind the Act.

Finally, the majority's reading of the legislative history is illogical. On the one hand, the majority contends, Congress was so concerned with organizational "dummies" set up for the sole purpose of avoiding the antifraud provisions of the Act that it enacted section 20(a) and (b) just to catch them. At the same time, however, the majority suggests that Congress deliberately gave these "dummy" organizations a good faith defense which it denied to ordinary controlling persons such as lawful employers.

To hold an individual liable for securities fraud committed by his employee without proof of fault, in addition to being contrary to the position of Congress established in its legislative history, would violate the express language of the Act. Section 20(a) extends the good faith defense to employers, and nowhere is there an express statutory provision for expanding employer liability under respondeat superior. Section 10(b) prohibits ma-

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[4]In this section and in section 11, when reference is made to "control", the term is intended to include actual control as well as what has been called legally enforceable control. . . . It was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or anticipate the many ways in which actual control may be exerted. A few examples of the methods used are stock ownership, lease, contract, and agency. 78 Cong. Rec. 7709 (1934) (daily ed. April 30, 1934 statement of Representative Rayburn); *accord* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 26 (1934).

nipulative or deceptive practices, but does not provide that it shall also be unlawful to employ a person who engages in such practices. When engaging in statutory interpretation, recent Supreme Court cases mandate that the courts consider only the actual language of the statute to divine Congressional intent, and not general principles of tort law or public policy. An analogy to those cases concerning when a private right of action is implied in federal securities cases is instructive. In *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979), the Court held that the lower court's reliance on tort principles to sustain a private cause of action under section 17(a) of the Securities Exchange Act of 1934 was "entirely misplaced." The Court stated that "[t]he invocation of the 'remedial purposes' of the 1934 Act is . . . unavailing. Only last Term we emphasized that generalized references to the 'remedial purposes' of the 1934 Act will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit.' " *Id.* at 578. *See also Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 15-16 (1979) (Court refused to imply a private damage remedy under section 201 of the Investment Advisers Act of 1940, holding that a court should not consider "the desirability of implying private rights of action in order to provide remedies thought to effectuate the purposes of a given statute.").[5] Thus the majority's broad interpretation of the statute in order to protect the public more comprehensively (*majority opinion* at 13936) should be rejected.

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[5]The Court, while never facing the issue directly, has stated that the existence of an implied private right of action under section 10(b) is "well established." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976).

Furthermore, the requirement of culpability underlying section 20(a) and the Act in general would be vitiated by the use of respondeat superior.[6] This policy is exemplified by Congress' refusal to place insurer's liability on brokerage firms when it enacted section 15 of the 1933 Act and section 20(a) of the 1934 Act. In addition, the Supreme Court, while never expressly addressing the precise question presented here, nevertheless has held that a Rule 10b-5 violation requires scienter, and assumed that all controlling persons are entitled to the protection of the good faith defense. In *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 (1976), the Court held that each liability provision of the 1934 Act "contains a state-of-mind condition requiring something more than negligence." The Court further noted that "§ 20, which imposes liability upon 'controlling person[s]' for violations of the Act by those they control, *exculpates* a defendant who 'acted in good faith and did not . . . induce the act . . . constituting the violation. . . . " *Id.* at 209 n. 28. (emphasis added).[7]

Respondeat superior, on the other hand, is a strict liability doctrine. *See* Restatement (Second) of Agency § 219 (1958) (stating that employees are servants, and a master is responsible for the torts of his servant when the

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[6]This requirement is not abridged by the use of aiding-and-abetting or conspiracy rules, because both of those theories, at least as they are employed under the federal securities laws, still require culpability on the part of the "secondary" defendant.

[7]Most courts have since held that failure to supervise constitutes recklessness and thus meets the scienter requirement, because of the high obligation owed by brokerage firms based upon their fiduciary role. *See, e.g., G.A. Thompson & Co. v. Partridge,* 636 F.2d 945, 959 (5th Cir. 1981) ("Liability based upon failure to supervise suggests recklessness. . . . "); *Carpenter v. Harris, Upham & Co.,* 594 F.2d 388, 394 (4th Cir.), *cert. denied,* 444 U.S. 868 (1979); *Zweig v. Hearst Co.,* 521 F.2d 1129, 1135 (9th Cir. 1975).

torts are done while the servant is acting within the scope of his employment). The only inquiry under the doctrine of respondeat superior is whether the individual's fraudulent act was committed within the scope of his employment;[8] any discussion of good faith, negligence, or a duty to supervise is irrelevant. As one of the major treatises on the subject recognizes:

> Vicarious liability . . . is imposed . . . in cases where the master has taken all the steps that reasonable foresight would suggest, including those which involve the exercise of control. Indeed, the court is not even interested in hearing whether the master exercised his right of control well and prudently.

F. Harper & F. James, Jr., *The Law of Torts* 1367 (1956).

In common actions like the present one based upon misrepresentation by employees in connection with the purchase and sale of securities, a broker-dealer will virtually never be able to prove that such a representation was made outside an employee's scope of employment. *See, e.g., Holloway v. Howerdd*, 536 F.2d 690 (6th Cir. 1976) (trial court concluded firm had met good faith defense but appellate court found firm vicariously liable for fraud of employee anyway as the brokerage firm "must be clearly disassociated from [the unlawful transactions] as otherwise it will incur liability on the basis of respondeat superior . . ."). Holding broker-dealers secondarily liable under the common law doctrine of respondeat superior would render superfluous section 20(a), for they would be

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[8] It is sufficient if an agent was acting in what reasonably appeared to the third party to be in the scope of his employment, under the doctrine of apparent authority. *See* Restatement (Second) of Agency § 265 (1958). Apparent authority liability is imposed even when the agent was acting solely for his own purposes, unless this is known to the person with whom the agent is dealing. *Id.* § 262.

responsible despite their having fulfilled a stringent good faith test based on their having maintained and enforced reasonable and proper supervision and internal controls. *See generally* W. Fitzpatrick & R. Carman, *Respondeat Superior and the Federal Securities Laws: A Round Peg In a Square Hole*, 12 Hofstra L. Rev. 1 (1983).

Section 28(a) of the 1934 Act[9] does not say otherwise. This section merely expresses Congress' intent not to preempt state or common law claims based on the same facts underlying the federal claims; it does not authorize courts to engraft inconsistent state or common law rights and remedies into this new federal securities fraud claim created, defined, and limited by the Act. As Representative Rayburn explained, "this subsection reserves rights and remedies existing *outside* of those provided in the act." 78 Cong. Rec. 7709 (1934). *See also Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 738 n. 9(1975) (where the Court did not allow a plaintiff who had been offered, but had not purchased, a security to maintain a cause of action under Rule 10b-5, but stated that under The Securities Exchange Act of 1934, § 28(a), a non-purchaser may have a cause of action under state law). Thus this section was not intended to engraft common law concepts into the provisions of the Act itself. Rather, the common law doctrine of respondeat superior can still apply where the predicate offense giving rise to vicarious liability is created by state law, such as in a tort-based fraud action.

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[9]Section 28(a) of the 1934 Act, 15 U.S.C. § 78bb (1976), provides in pertinent part:

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity.

While I realize that several other circuits have reached the opposite conclusion on this issue, there is not as strong a consensus as the majority suggests.[10] *Majority opinion* n. 26. As the majority admits, there is some confusion over what the law is in the Fourth Circuit. *See Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir.) (court found that Congress intended civil liability of sellers of securities to be premised on scienter, thus the employer in this case, though a controlling person, is not liable for the securities violation of its employee because it adequately supervised him), *cert. denied*, 444 U.S 868 (1979); *Haynes v. Anderson & Strudwick, Inc.*, 508 F.Supp. 1303 (E.D. Va. 1981) (court held that the common law doctrine of respondeat superior and vicarious liability under section 20(a) cannot sensibly or fairly operate concurrently, and since Congress has specifically granted the broker-dealer the good faith defense contained in section 20(a) it is the exclusive standard of liability).

Holloway v. Howerdd, 536 F.2d 690 (6th Cir. 1976), upon which the majority rely for the proposition that the Sixth Circuit holds that section 20(a) supplements respondeat superior, can be as easily read to support the dissenting position. Although not completely clear from the opinion, it appears that the court applied respondeat superior to a common law cause of action, not to a federal securities violation. "The use of the doctrine of respon-

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[10]The Third Circuit has held that generally respondeat superior may *not* serve as a basis for secondary liability under Rule 10b-5, but carves out an exception for broker-dealers and accounting firms. *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 181 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

The Seventh, Eleventh, and District of Columbia Circuits have apparently not spoken on this issue.

deat superior to impose liability on TSI must be predicated on a finding that Tucker engaged in some illegal activity. The District Judge imposed liability on TSI on the basis that its employee, Tucker, was guilty of fraud and misrepresentation in his sale of Modular shares." *Id.* at 695. This interpretation is bolstered by the court's refusal to award attorney's fees to the plaintiff. "Liability has been imposed on TSI under the common law doctrine of respondeat superior for the misdeeds of its agent; however, *TSI has been absolved of any liability arising under the Securities Act of 1933 itself.* Therefore the statutory authorization for an award of attorney's fees [15 U.S.C. § 77k(e)] cannot be applied because the liability of TSI does not originate in the Act but in the common law." *Id.* at 697 (emphasis added). *See also SEC v. Washington County Util. Dist.,* 676 F.2d 218, 224 n. 11 (6th Cir. 1982), ("In essence, the Commission, in *Coffey,* attempted to hold King liable on the basis of respondeat superior. We refused to impose liability on that theory. *Coffey,* 493 F.2d at 1315. *Accord, Rochez Brothers, Inc. v. Rhoades,* 527 F.2d 880, 886 (3d Cir. 1975); *Zweig v. Hearst Corp.,* 521 F.2d 1129 (9th Cir. 1975.)").

Though it is true that the First, Second, Third, Eighth and Tenth Circuits hold to the contrary, we are not, of course, bound by those decisions. Following the letter of the statute and allowing a broker-dealer his good faith defense in no way diminishes his obligation under the Act. He is still accountable, both administratively to the Commission and civilly to the public, for his misdeeds and failure to supervise his employees. The public is well protected by state, federal, and common law without subjecting employers to insurer liability for acts they did not commit and could not have reasonably anticipated or guarded against. Therefore, I respectfully DISSENT.

APPENDIX B

APPENDIX B

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

KAY HOLLINGER, et al.,
Plaintiffs,
vs.
TITAN CAPITAL CORPORATION,
a foreign corporation; et al.,
Defendants.

February 13, 1987
No. C84-1706D

ORDER

Defendant Titan Capital Corporation ("Titan") moves for summary judgment dismissal of plaintiffs' federal causes of action brought under the federal securities laws and RICO, and dismissal of plaintiffs' pendent state claims. While plaintiffs make many allegations with respect to Titan's liability for violations of the securities laws, of particular concern is the extent of liability of a broker dealer as a "controlling person" for violations of the securities laws by one of its registered representatives. Under the undisputed facts of this case, the court concludes that Titan is neither a "controlling person" nor liable under the federal securities laws or RICO. Summary judgment on these claims is granted and the plaintiffs' pendent state claims are dismissed without prejudice.

SUMMARY JUDGMENT STANDARD

In considering a motion for summary judgment, the evidence and inferences must be viewed in the light most

favorable to the party opposing the motion. *Bell v. Cameron Meadows Land Co.*, 669 F.2d 1278, 1280 (9th Cir. 1982). A movant is entitled to summary judgment on a claim when the nonmoving party has failed to make a sufficient showing on an essential element of the nonmoving party's case with respect to which the nonmovant has the burden of proving at trial. *Celotex Corp. v. Catrett*, 106 S.Ct. 2548, 2552, 91 L.Ed.2d 265 (1986). The burden on the moving party may be discharged by showing that there is an absence of evidence to support the nonmoving party's case. *Celotex*, 106 S.Ct. at 2554.

FEDERAL CLAIMS

1. *Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.*

Plaintiffs assert that Titan violated the antifraud provisions of the securities laws, section 10(b) (15 U.S.C. § 78j) and Rule 10b-5 promulgated thereunder (17 C.F.R. § 240.10b-5).[1] To establish primary liability under section

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[1]Rule 10b-5 details the general requirements of section 10(b):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud,
>
> (b) to make any untrue statement of a material fact, or to omit to state a material fact, necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

10(b) and Rule 10b-5, the plaintiff must establish that the defendant intentionally or recklessly misrepresented or failed to disclose a material fact in connection with the purchase or sale of securities. *Securities & Exchange Commission v. Rogers*, 790 F.2d 1450 (9th Cir. 1986). Scienter is defined as an intent to deceive or defraud. *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 739 F.2d 1434, 1435 (9th Cir. 1984). Recklessness is defined as a willful or wanton disregard of the consequences of an act or failure to act. The recklessness that is required by section 10(b) is close to a lesser form of intent to deceive than merely a greater degree of ordinary negligence. *Id.*; *Black's Law Dictionary* (5th ed. 1979).

It is clear that Titan had no knowledge that Wilkowski was defalcating funds placed with Wilkowski for investment. Rather, plaintiffs contend that Titan deliberately or recklessly misrepresented or omitted material facts when it failed to inform plaintiffs that Wilkowski had a criminal record. There are several reasons why such a claim does not state a cause of action under section 10(b), including lack of a duty to disclose and lack of materiality. *See Zweig v. Hearst Corp.*, 594 F.2d 1261, 1267-68 (9th Cir. 1979). More importantly, the NASD cleared Wilkowski to represent Titan, giving Wilkowski an unconditional license notwithstanding Wilkowski's prior criminal record. The NASD's action forecloses any claim that Titan was reckless in hiring Wilkowski or failing to inform investors of Wilkowski's criminal record.

2. Titan's Liability as a Controlling Person.

Plaintiffs assert that Titan is liable under the securities laws for the violations of Wilkowski, who was acting as an agent on Titan's behalf. The established law of the Ninth Circuit is that section 20(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78t(a)) and section 15 of the

Securities Act of 1933 (15 U.S.C. § 77o) supplants the doctrine of respondeat superior. *Buhler v. Audio Leasing Corp.*, No. 85-4044, slip. op. at 5-6 n.4 (9th Cir. Jan. 6 1987) (citing *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 667 (9th Cir. 1978); *Zweig v. Hearst Corp.*, 521 F.2d 1129, 1132 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975)).[2] Section 20(a) provides that:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

To establish that a defendant is a "controlling person" a plaintiff generally must show that (1) the defendant had actual power or influence over the allegedly controlled person and (2) the defendant was a culpable participant in the alleged illegal activity. *Buhler v. Audio Leasing Corp.*, No. 85-4044, slip. op. at 6; *Kersh v. General Council of Assemblies of God*, 804 F.2d 546 (9th Cir. 1986); *Christoffel*, 588 F.2d at 668. Whether a defendant has power or influence over an allegedly controlled person is a question of fact. *Buhler*, slip. op. at 6 (citing *Kersh v. General Council of Assemblies of God*, 804 F.2d 546, 548 (9th Cir. 1986)). In light of the Ninth Circuit's recent

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[2]While plaintiffs did not expressly allege violations of sections 20(a) or 15 in their complaint, they did affirmatively allege that Titan failed to properly supervise Wilkowski and breached a fiduciary duty owed to the plaintiff investors. Both the plaintiffs and the defendant addressed section 20(a) in their memoranda in opposition to and in support of this motion for summary judgment.

opinion in *Buhler v. Audio Leasing Corp.*, however, it is evident that the facts of the present case do not reflect that degree of power or influence necessary to establish that Titan is liable as a "controlling person."

(a) Actual Power or Influence

Plaintiffs admit that Titan and Wilkowski contractually agreed that as an independent sales agent, Wilkowski would be free from control and supervision by Titan. Although Wilkowski was directed to follow Titan's internal rules for operating a branch office, and Titan reserved the right to perform such supervisory overview as required by the Securities and Exchange Commission and other securities regulatory agencies, under *Buhler* such facts do not establish that Titan had actual power and influence over Wilkowski. Titan had no control over Wilkowski's defalcation of funds. Wilkowski was not authorized to accept payments in the form of cash or personal checks. None of Wilkowski's defalcations were consummated through the use of any Titan account. Titan received no income or benefit from the transactions consummated through Wilkowski and subsequently defalcated. Without more, an agreement between an independent sales agent and a broker dealer that the agent will effect buy/sell orders for securities exclusively through the broker dealer is insufficient to establish actual power or influence.

(b) Culpable Participation

Plaintiffs assert that Titan is liable as a controlling person because it failed to supervise Wilkowski's acceptance of funds for investment. The Ninth Circuit acknowledges "indirect participation" as a theory for establishing the culpable participation component in the context of security broker dealers, referred to as the "broker dealer

rule." *Buhler*, slip. op. at 7; *Kersh*, 804 F.2d at 550. In the broker dealer context, failure to supervise an agent constitutes "indirect participation" in the agent's illegal acts, subjecting the broker dealer to secondary liability under section 20(a). *Kersh*, 804 F.2d at 550; *see Buhler*, slip. op. at 7. In *Buhler*, the trial court found that the broker dealer had no duty to supervise because it had no knowledge of the type of security sales that were being made, the broker dealer had adopted rules against sales of unapproved securities, and the broker dealer had received no income from the sales.

Similarly, Titan had no knowledge that Wilkowski was accepting payments from investors in cash and by personal check or that Wilkowski was misappropriating these funds. Titan had adopted rules for accepting investment payments and for supervising a contractor's compliance with securities laws and regulations. It would be difficult if not impossible for Titan to supervise all investment orders transacted by its independent sales agents to ensure that funds were properly transferred to issuers or custodian banks rather than to the agent's personal account. If this Court were to impose such a duty it would in effect be imposing an "insurer's liability" standard on broker dealers which Congress and the Ninth Circuit has refused to do. *Christoffel*, 588 F.2d at 668 (citing H.R. Rep. No. 85, 73d Cong., 1st Sess. 27 (1933); H.R. Rep. No. 152, 73d Cong., 1st Sess. 27 (1933); S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933)). Unlike the facts in *Buhler*, Titan required sales to be made from under its "logo" by requiring Titan's name to be used on business stationery and on signs at branch offices, and plaintiffs dealt directly with Titan on some occasions. Notwithstanding this appearance of participation, however, the plaintiffs did not rely on Titan's participation in any way but rather looked only to Wilkowski for guidance in their investments.

Plaintiffs Hollinger and D'Arcy dealt with Wilkowski prior to his affiliation with Titan. They appointed him secretary-treasurer of their private investment company, PIC, created to serve as an investment vehicle. Plaintiffs never sought verification from Titan for any of the investment transactions effected through Wilkowski. Under these facts, Titan did not have a duty to supervise the unauthorized actions of Wilkowski, and any failure to supervise cannot be characterized as participation. *Buhler,* slip. op. at 8. Summary judgment as to Titan's liability as a controlling person is granted.

3. *Plaintiffs' Claim Under Section 15 of the Securities Exchange Act of 1934.*

The Ninth Circuit has held that as a matter of law, no private right of action is to be implied under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. § 78o). *Securities Exchange Commission v. Seaboard Corp.*, 677 F.2d 1301, 1313-14 (9th Cir. 1982). Summary judgment dismissing the claim under section 15 of the Securities Exchange Act of 1934 is granted.

4. *Section 17(a) of the Securities Act of 1933*

Under section 17(a) (15 U.S.C. § 77q(a)), it is a violation to engage in any scheme to defraud in connection with the sale of a security.[3] The Ninth Circuit has

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[3]Section 17(a) of the Securities Act of 1933 provides:

> It shall be unlawful for any person *in the offer or sale* of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —
>
> (1) to employ any device, scheme or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material

taken the position that an implied right of action exists under section 17(a). *Mosher v. Kane,* 784 F.2d 1385, 1390 n.9 (9th Cir. 1986), *cert. denied,* 107 S.Ct. 189, 93 L.Ed. 2d 122 (1986). While the Ninth Circuit has declined to decide the question, several courts have held that section 17(a) of the 1933 Act is narrower in scope than section 10(b) of the 1934 Act. *See Mosher,* 784 F.2d at 1391. However, even if this Court assumes that section 17(a) is as broad in scope as section 10(b), plaintiffs' section 17(a) claim fails for the same reasons as the section 10(b) claim. Plaintiffs have failed to establish that Titan intentionally or recklessly misrepresented or failed to disclose a material fact in connection with the sale of a security. *See SEC v. Rogers,* 790 F.2d at 1458.

5. *Section 12(2) of the Securities Act of 1933*

As to its claim under section 12(2) (15 U.S.C. § 771), plaintiffs have abandoned allegations that Titan is primarily liable for violations of section 12(2) and instead assert that Titan is liable as a "controlling person." Having found that Titan is not liable as a controlling person, plaintiffs' section 12(2) claim is dismissed.

6. *RICO*

Plaintiffs as much as concede the deficiencies in their RICO claim. In their response to Titan's motion for summary judgment, plaintiffs argue that Wilkowski's violation of section 10(b) of the Securities Exchange Act of

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fact necessary in order to make the statement made, in light of the circumstances under which they were made not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (emphasis added.)

1934 is a predicate act for RICO, that recklessness can rise to the level of scienter necessary for a 10(b) violation, therefore, Titan's recklessness can also rise to the level of knowledge necessary to impose liability under RICO. For their RICO claim, plaintiffs use the same theory of recklessness that they used in asserting their sections 10(b) and 17(a) claims, that Titan was reckless in employing a representative with a criminal record and in failing to inform investors that the representative had a criminal record. This theory for imposing liability has already been rejected. Since recklessness necessary for a section 10(b) claim is absent, recklessness is insufficient to support plaintiffs' RICO claim.

STATE CLAIMS

Having found that no grounds exist for plaintiffs' federal securities and RICO claims, this Court lacks subject matter jurisdiction over plaintiffs' pendent state claims. When federal claims are dismissed before trial, pendent state claims also should be dismissed. *United Mine Workers v. Gibbs,* 383 U.S. 715, 726 (1966); *Jones v. Community Redevelopment Agency,* 733 F.2d 646, 651 (9th Cir. 1984). Plaintiffs' state claims are dismissed without prejudice.

CONCLUSION

After hearing oral argument and considering the memoranda, affidavits, and supporting documents submitted by counsel, the Court finds no genuine issues of fact as to plaintiffs' federal securities claims.

THEREFORE, defendant Titan's motion for summary judgment as to plaintiffs' claims under sections 10(b), 15 and 20(a) of the Securities Exchange Act of 1934, Rule

10b-5 promulgated thereunder, sections 12(2), 15 and 17(a) of the Securities Act of 1933, and RICO, 18 U.S.C. § 1961 *et seq.*, is GRANTED. Plaintiffs' pendent state claims are likewise DISMISSED WITHOUT PREJUDICE. Although defendant Painter Financial Group, Ltd. is not a party to the present motion, SUA SPONTE the claims asserted against defendant Painter will be DISMISSED 30 days from the date of this Order unless plaintiffs can show that genuine issues of material fact exist as to Painter's liability.

The Clerk of the Court is instructed to send a copy of this Order to all counsel of record.

DATED this 13th day of February, 1987.

CAROLYN R. DIMMICK

CAROLYN R. DIMMICK
United States District Judge

APPENDIX C

APPENDIX C

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

KAY HOLLINGER, et al.,
Plaintiffs,

vs.

TITAN CAPITAL CORPORATION,
a foreign corporation; et al.,
Defendants.

April 20, 1987

No. C84-1706D

ORDER

Plaintiffs Hollinger, Jones, Nissen, D'Arcy, and K-Judy, Ltd. move for reconsideration of this Court's Order of February 13, 1987. That Order granted summary judgment dismissal of plaintiffs' federal causes of action brought under the federal securities laws, RICO and pendent state claims. Plaintiffs also respond to the Court's Order to show cause why plaintiffs' cause of action against defendant Painter Financial Group, Ltd. should not be dismissed *sua sponte*. Finding no basis for reconsideration of its Order, plaintiffs' motion is denied. And having failed to show that genuine issues of fact exist as to Painter's liability, plaintiffs' claims against Painter are also dismissed. Titan's request that sanctions and costs be imposed against plaintiffs is denied.

PRIMARY RESPONSIBILITY
UNDER RULE 10b-5 & SECTION 17(a)

Plaintiffs' first ground for reconsideration is that the Court granted summary judgment on Titan's primary

liability for violation of Rule 10b-5 and section 17(a) on grounds that were not raised by the parties, thus plaintiffs did not have an opportunity to present evidence and brief the issues. Specifically, they urge that while facts were presented which show that the NASD registered Wilkowski to sell securities, the effect such registration may have on a determination of Titan's liability was "not briefed" thus the Court should reopen the matter. The effect of NASD licensing does not present a new legal theory and is not an appropriate basis for reconsideration because plaintiffs merely misunderstand the basis of the Court's ruling on Titan's liability under Rule 10b-5 and section 17(a). Plaintiffs' misunderstanding results in part from their failure to distinguish between primary liability and secondary liability for violations of the securities laws.

In their complaint and memoranda plaintiffs alleged that Titan was liable for violations of Rule 10b-5 and section 17(a) because of unlawful acts committed by Wilkowski. Scienter is required to impose primary liability under Rule 10b-5 and section 17(a). Plaintiffs do not contend that Titan had any knowlege of Wilkowski's unlawful conduct. Rather, plaintiffs contend that the scienter requirement is satisfied by showing that Titan, knowing that Wilkowski was convicted of forgery in 1972, was reckless in that Titan (1) failed to disclose the conviction to investors, and (2) allowed Wilkowski to sell securities without allegedly adequate supervision. Plaintiffs are wrong. As to (1), Titan had no duty to disclose Wilkowski's 1972 conviction. As to (2), negligent conduct is not grounds for imposing *primary* liability under Rule 10b-5 or section 17(a).

Titan's failure to inform investors of Wilkowski's 1972 conviction is not grounds for imposing primary liability

under Rule 10b-5 or section 17(a) because Titan had no duty to disclose the forgery conviction. A party must have a duty to disclose information before his failure to do so will support liability. *SEC v. Rogers,* 790 F.2d 1450, 1459 (9th Cir. 1986); *Strong v. France,* 474 F.2d 747, 752 (9th Cir. 1973). A broker dealer has a duty to disclose to the Securities Exchange Commission ("SEC") and the National Association of Securities Dealers ("NASD") that a representative or applicant for registration has a forgery conviction. *See* Securities Exchange Act of 1934 § 15, 15 U.S.C. §§ 78o, 78o-3. But there is no evidence that Titan failed to comply in any way with the manner of Wilkowski's registration. *See* 15 U.S.C. § 78o(a), (b) and § 78o-3(g)(1), (2). If, however, the SEC or the NASD had registered Wilkowski to sell securities without knowing of Wilkowski's forgery conviction, and Titan, knowing of the conviction failed to disclose such information, then Titan would have been primarily liable for fraudulently holding out to investors a seemingly qualified seller of securities who was statutorily disqualified by 15 U.S.C. § 78o(b)(4)(B)(iii). But the NASD was aware of Wilkowski's forgery conviction, he was not disqualified from selling securities, and no restrictions were placed on his registration.

Furthermore, while the Act imposes a duty on broker dealers to inform the SEC and NASD of convictions not disclosed by applicants for registration, nothing in the language of section 10(b), Rule 10b-5, section 17(a) or any other portion of the Act indicates that Titan had a legal duty to inform the investing public of Wilkowski's forgery conviction. Titan cannot be held primarily liable for allowing Wilkowski to sell securities to the public or for failing to disclose Wilkowski's criminal record to the investing public when all statutory requirements for Wilkowski's registration were met.

In their motion for reconsideration, plaintiffs continue to assert that Titan's allegedly inadequate supervision of Wilkowski is grounds for imposing primary liability under Rule 10-b and section 17(a). Admittedly, the mere fact that a representative is statutorily qualified and registered to sell securities does not necessarily discharge the obligations of a controlling person. But Titan's alleged inadequate supervision of Wilkowski is an issue that goes to a determination of *secondary* liability under section 20(a) not primary liability under Rule 10b-5 or section 17(a). In other words, negligent conduct may form the basis for imposing secondary liability on a controlling person under section 20(a), but negligence is not a grounds for imposing primary liability under Rule 10b-5 or section 17(a).

SECONDARY LIABILITY UNDER SECTION 20(a)

Plaintiffs' second ground for reconsideration is that plaintiffs were unable to argue or present evidence on the application of *Buhler v. Audio Leasing Corp.*, No. 85-4044, slip op. (9th Cir. Jan. 6, 1987) to the present case. The evidence offered by plaintiffs in support of their motion for reconsideration is not new evidence, and plaintiffs' instruction on the application of *Buhler* to the facts of this case is unnecessary. The Court concludes that under the law of this Circuit, Titan is not liable as a controlling person.

PLAINTIFFS' CLAIMS AGAINST DEFENDANT PAINTER

Plaintiffs present no evidence showing why plaintiffs' claims against Painter Financial Group, Ltd. should not be dismissed *sua sponte*. For the reasons that the Court dismissed the claims against Titan in the Order of

February 13, 1987, the claims against Painter are also dismissed.

CONCLUSION

Plaintiffs' motion for reconsideration is DENIED. Pursuant to the Court's Order of February 13, 1987, *sua sponte* plaintiffs' claims againt Painter Financial Group, Ltd. are DISMISSED.

The Court concludes that there is no just reason for delay in the entry of final judgment as to claims against Titan and Painter, therefore the Clerk of the Court is directed to enter final judgment dismissing all claims against defendants Titan and Painter.

The Clerk of the Court is instructed to send a copy of this Order to all counsel of record.

DATED this 20th day of April, 1987.

CAROLYN R. DIMMICK

CAROLYN R. DIMMICK
United States District Judge

APPENDIX D

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STATUTES AND REGULATIONS INVOLVED

Securities Act of 1933

Section 12(2), 15 U.S.C. § 77l(2):

Any person who —

* * *

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideraton paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 15, 15 U.S.C. § 77o:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Securities Act of 1934

Section 10(b), 15 U.S.C. § 78j(b):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 20(a), 15 U.S.C. § 78t(a):

> (a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Section 28(a), 15 U.S.C. § 78bb(a):

> (a) The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.

Securities and Exchange Commission,

17 C.F.R. § 230.405:

> Unless the context otherwise requires, all terms used in §§ 230.400 to 230.494, inclusive, or in the forms for registration have the same meanings as in the Act and in the general rules and regulations. In

addition, the following definitions apply, unless the context otherwise requires:

* * *

Control. The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

17 C.F.R. § 240.10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. § 240.12b-2:

Unless the context otherwise requires, the following terms, when used in the rules contained in this regulation or in Regulation 13A or 15D or in the

forms for statements and reports filed pursuant to sections 12, 13 or 15(d) of the act, shall have the respective meanings indicated in this rule:

* * *

Control. The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.